

SELECTED CONSOLIDATED FINANCIAL DATA, continued

	December 31, 2005	December 31, 2004	December 31, 2003	December 31, 2002	December 31, 2001
Balance Sheet Data:					
Cash and short-term investments	\$ 41,141	\$ 31,696	\$ 26,715	\$ 25,282	\$ 25,042
Working Capital	52,535	44,147	36,197	28,625	26,238
Total assets	87,601	76,663	63,123	61,666	60,394
Shareholders' equity	72,769	60,398	50,607	47,768	45,781

Notes to Selected Consolidated Financial Data

- We adopted Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB 101) for our fiscal year ended October 31, 2000, implementing a change in accounting in regard to revenue generated from clients seeking reimbursement from third-party payors where our fees are contingent upon the client's collections from third parties.

As of October 31, 1999, we had unbilled accounts receivable of \$41.7 million related to our prior revenue recognition policy that had not been invoiced to clients because we were contractually obligated to invoice the client only after they received payment from the responsible third party payors. Of this amount, we subsequently recognized the following amounts in revenue and operating results and there are no remaining amounts to be recognized:

<u>Period</u>	<u>Revenue</u> (in thousands)
Prior to Fiscal 2001	\$19,838
Fiscal 2001	4,053
Fiscal 2002	1,062
Fiscal 2003	645
Fiscal 2004	<u>640</u>
	<u>\$26,238</u>

- Discontinued Operations.** In 2005 we sold our Accordis business. In fiscal year 2001, we sold Health Care microsystems, Inc. which operated as our Decision Support Group (DSG), and implemented a formal plan to close the Payor Systems Group (PSG) through an orderly wind-down of its operations. As these businesses were previously presented as separate reportable segments and represented separate classes of customers and major businesses, the operating results are presented as discontinued operations for all periods presented.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

We begin Management's Discussion and Analysis of Financial Condition and Results of Operations with a discussion of the critical accounting policies that we believe are important to understanding the assumptions and judgments incorporated in our reported financial results. In the next section, we present an overview of our business and operations. This is followed by a discussion of our results of operations, including results of our operating segments, for the past two fiscal years. We then provide an analysis of our liquidity and capital resources, including discussions of our cash flows, sources of capital and financial commitments.

The following discussions should be read in conjunction with the other sections of this Report, including the Consolidated Financial Statements and Notes thereto appearing in Item 8 of this Report, the Risk Factors appearing in Section 1A of this Report and the disclaimer regarding forward-looking statements appearing at the beginning of Item 1 of this Report. Historical results set forth in Item 6 and Item 8 of this Report should not be taken as indicative of our future operations.

Critical Accounting Policies

Revenue Recognition. We principally recognize revenue for our service offerings when third party payors remit payment to our customers. This policy is in effect because our fees are principally contingent upon our customers' collections from third parties. Due to this revenue recognition policy, our operating results may vary significantly from quarter to quarter because of the timing of such collections by our customers and the fact that a significant portion of our operating expenses are fixed.

Accounting for Income Taxes. After utilizing net operating loss carry-forwards to offset taxable income in 2005, we have cumulative federal net operating loss carry-forwards of \$11.2 million as of December 31, 2005. In addition to other items expensed for financial reporting purposes that were not currently deductible for tax purposes, these net operating loss carryforwards result in gross deferred tax assets. We must assess the likelihood that the gross deferred tax assets, net of any deferred tax liabilities, will be recovered from future taxable income and to the extent we believe the recovery is not likely, we have established a valuation allowance.

Significant management judgment is required in determining this valuation allowance. We have recorded a valuation allowance of \$3.3 million as of December 31, 2005, due to uncertainties related to our ability to utilize some of our deferred tax assets, primarily consisting of the capital loss carryforward from the sale of Accordis before it expires. The valuation allowance is based on our estimate of taxable income and the period over which the net deferred tax assets will be recoverable. In the event that these estimates differ or we adjust these estimates in future periods we may need to establish an additional valuation allowance which could materially impact our financial position and results of operations.

Conversely, if we are profitable in the future at levels that cause management to conclude that it is more likely than not that we will realize all or a portion of the net deferred tax assets, for which a valuation is currently provided, we would record the estimated net realizable value of the net deferred tax asset at that time and would then provide income taxes at a rate equal to our combined federal and state effective rate of approximately 43%.

The net deferred tax asset as of December 31, 2005 was \$10.4 million, which is net of a valuation allowance of \$3.3 million.

Valuation of long lived and intangible assets and goodwill. Goodwill, representing the excess of acquisition costs over the fair value of net assets of acquired businesses, is not amortized but is reviewed for impairment at least annually and written down only in the periods in which it is determined that the recorded value is greater than the fair value. For the purposes of performing this impairment test, our business segments are our reporting units. The fair values of those reporting units, to which goodwill has been assigned, is compared with their recorded values. If recorded values are less than the fair values, no impairment is indicated. Since adoption, no impairment losses have been recorded.

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- Significant underperformance relative to expected historical or projected future operating results;
- Significant changes in the manner of our use of the acquired assets or the strategy for our overall business;
- Significant negative industry or economic trends;
- Significant decline in our stock price for a sustained period; and
- Our market capitalization relative to net book value.

We determine the recoverability of the carrying value of our long-lived assets based on a projection of the estimated undiscounted future net cash flows expected to result from the use of the asset. When we determine that the carrying value of long-lived assets may not be recoverable, we measure any impairment by comparing the carrying amount of the asset with the fair value of the asset. For identifiable intangibles, we determine fair value based on a projected discounted cash flow method using a discount rate reflective of our cost of funds.

Estimating valuation allowances and accrued liabilities, such as bad debts, and restructuring charges. The preparation of financial statements requires our management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. In particular, management must make estimates of the uncollectability of our accounts receivable. Management specifically analyzes accounts receivable and analyzes historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. The accounts receivable balance was \$19.0 million, net of allowance for doubtful accounts of \$0.7 million as of December 31, 2005.

As part of the proceeds from the sale of Accordis, we received a five-year promissory note of \$6 million, bearing interest at 6% per annum and requiring semi-annual principal payments of \$100,000, with the balance of \$5.1 million due in a balloon payment on August 31, 2010. At December 31, 2005, the Company has a Note Receivable with a present value of approximately \$5.5 million. In preparing our financial statements, management is required to assess the collectibility of this Note Receivable and has determined that no allowance is required at December 31, 2005. Future changes in the assessment of the collectibility of this Note Receivable could materially impact our results of operations.

Management has reviewed its estimates related to restructuring reserve at December 31, 2005 and believes that the estimated liability is based on a reasonable assessment of the probable costs to be incurred. As additional information becomes available, we may revise our estimates. Such revisions in estimates of the potential restructuring liabilities could materially impact the results of operation and financial position.

Discontinued Operations. The accompanying financial statements are prepared using discontinued operations accounting for our discontinued Accordis business. The net assets of Accordis sold excluded certain liabilities retained by us of approximately \$0.6 million, consisting principally of liabilities associated with Accordis customers and former employees. A major client of Accordis has filed a claim against Accordis for certain alleged processing errors in submitting claims on behalf of the client. In connection with the sale of Accordis, the Company agreed to indemnify Accordis and its buyer with respect to this claim. See Item 3. Legal Proceedings. As part of the sale, we also agreed to indemnify the buyer for liabilities in connection with Accordis that arose prior to the sale of Accordis on August 31, 2005. The buyer agreed to indemnify us for liabilities in connection with Accordis that arise after the sale. There is a minimum indemnification claim threshold of \$250,000 that is computed after taking into account any insurance proceeds. Our liability under the indemnification provisions of the Accordis sale documents is capped at the sale price. The Company is not aware of any potential claims under the indemnification provisions of the sale agreements but in the event that any liabilities should arise from these discontinued operations in excess of the amounts recorded, there could be a material impact on our results of operations.

New Accounting Pronouncement. On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123R), which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123R supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and amends SFAS No. 95, "Statement of Cash Flows." Generally, the approach in SFAS No. 123R is similar to the approach described in SFAS 123. However, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. SFAS No. 123R must be adopted no later than the first interim or annual period beginning after June 15, 2005.

As permitted by SFAS No. 123, we currently account for share-based payments to employees using APB Opinion No. 25's intrinsic value method and, as such, generally recognize no compensation cost for employee stock options. We will adopt SFAS No. 123R on January 1, 2006 using the modified prospective application option. As a result, the compensation cost for the portion of awards we granted before January 1, 2006 for which the requisite service has not been rendered and that are outstanding as of January 1, 2006 will be recognized as the remaining requisite service is rendered. In addition, the adoption of SFAS No. 123R will require us to change from recognizing the effect of forfeitures as they occur to estimating the number of outstanding instruments for which the requisite service is not expected to be rendered. Accordingly, the adoption of SFAS No. 123R's fair value method will have a significant impact on our results of operations. The impact of the adoption of SFAS No. 123R cannot be determined at this time because it will depend upon levels of share-based payments granted in the future. However, had we adopted SFAS 123R in prior periods, the impact of that standard would have approximated the impact as described in the disclosure of pro forma net income and net income per share pursuant to SFAS No. 123 in Note 1 of Notes to Consolidated Financial Statements.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by accounting principles generally accepted in the United States of America, with no need for management's judgment in their application. There are also areas in which the audited consolidated financial statements and notes thereto included in this Form 10-K contain accounting policies and other disclosures required by accounting principles generally accepted in the United States of America.

Overview

Our work is highly customized to the needs of each client, and to the specifications of individual projects. Each client engagement is unique, and requires significant up-front investment, sometimes well before the engagement generates revenue. There are, however, a number of processes that are fundamental to servicing our clients and which cut across all product offerings. Incorporated into these processes are key performance indicators that support our core operating methodology.

One of our most critical resources is the information that we use to identify other available sources of insurance coverage. In 2005, HMS continued to build its proprietary database of insurance eligibility information. We added more than 40 insurance carriers and other healthcare entities to our network of data exchange partners, representing an addition of 34 million insurance beneficiaries. We believe this repository of eligibility information is the largest of any vendor in the industry. At the conclusion of 2005, our data exchange network comprised a total of 153 sources, covering a total of 157 million lives. In 16 states, we have captured eligibility data for more than 90% of the population.

HMS continually strives to maximize the portion of client expenditures that we recover through our proprietary "Yield Management" process. By conducting in-depth analyses of our recovery performance from multiple perspectives – for example, by comparing results by carrier or by provider – our Yield Management Team pinpoints new opportunities to capture recoveries, helps us set measurable goals for improvement, and increases our contingency fee revenue. We estimate that our Yield Management process boosts recoveries for clients by 25% to 30%. In 2005, Health Management Systems submitted approximately \$250 million in billings through this process.

By listening closely to our clients, we often discover the need for a new product or service that provides them long-term value. In 2005, as government healthcare programs focused new attention on payment integrity, HMS expanded its menu of overpayment recovery services. Through internal development and strategic partnerships, we gained new tools for identifying and recovering expenditures that result from fraudulent, abusive, or wasteful billing. We also began our first client engagement devoted solely to overpayment recovery – with the Idaho Medicaid program. To date, across all our clients, we have recovered a total of more than \$417 million in overpayments.

In 2005, we invested significant resources in the development of proprietary tools to streamline the flow of information among clients, payors, and providers. These tools included *COBManager*, our proprietary application for coordinating benefits in near-real-time, which was implemented fully among pharmacy providers on behalf of our New Jersey Medicaid client. By strengthening communication among our company and our clients, we believe we will better serve clients, and better participate in healthcare's "open" information environment.

Leveraging our work on behalf of state Medicaid programs, HMS has successfully penetrated the Medicaid managed care market. Medicaid health plans represent a burgeoning opportunity for our Company, especially as Medicaid moves more and more of its membership to these plans. We see additional opportunity among the plans that now are beginning to serve the Medicare program – either as Medicare Advantage contractors, which provide a full array of health benefits, or Medicare prescription drug plans, which offer the new drug benefit under Medicare Part D. In 2005, we cultivated new resources to pursue these opportunities. We restructured HMS' operations and services, forming two dedicated business units: Government Services and Managed Care Services. By channeling distinct capabilities to their respective markets, we expect these units to propel our growth in the coming years. At the conclusion of 2005 we counted 11 health plans – including several of the largest in the nation – as our clients.

Holdings' revenue, most of which is derived from contingent fees, has grown approximately 18% per year for the last four years. This growth has been partly attributable to the growth in Medicaid costs, which has averaged approximately 10% annually. State governments also have increased their use of vendors for coordination of benefits and other cost containment functions, and we have been able to increase our revenue through the initiatives previously discussed. While there is no certainty that Holdings will be successful in obtaining new contracts, expanding existing contracts, or continuing to leverage internal initiatives to support growth, we are projecting that Holdings' revenue will grow approximately 15% in 2006.

It should be noted that the nature of our business sometimes leads to significant variations in revenue flow. For example, since we receive contingency fees for nearly all our services, we recognize revenue only after our clients have received payment from a third party. In addition, much of our work occurs on an annual or project-specific basis, and does not necessarily recur monthly or quarterly, as our operating expenses do. See a more detailed discussion in Item 1A.-Risk Factors.

As a service company, 44% to 47% of our operating expenses are compensation. We adjust our employee headcount based on known business needs and expectations about the near-term future. Based on recent operating results, we realize that compensation expense does tend to grow with increases in revenue – although not on a proportional basis, since many employee functions do not require additional staff as revenue increases.

Our revenue growth over the past several years has not resulted in significant changes in occupancy expenses. Data processing expenses have increased over the past year as we have increased capacity in our mainframe environment operation while incurring expenses related to migrating from the mainframe environment to a primarily server-based platform by 2008.

Direct project expenses are incurred based on the requirements of each client engagement. On average, these expenses have amounted to approximately 15% to 17% of revenues annually.

Other operating expenses reflect the customary costs of doing business, such as insurance, legal fees, accounting and tax fees, and costs associated with the requirements of being a publicly traded company. Significant components of this expense category are costs of necessary external professional services, travel and entertainment, employee recruiting, training, and office materials.

The following discussions reflect the results of Accordis as discontinued operations in all periods presented. For periods prior to August 31, 2005 (the date of the sale of Accordis), the results of Accordis presented as discontinued operations include that portion of corporate overheads directly attributable to Accordis. Concurrently with the Accordis sale, we also entered into several other agreements including (i) a three year Data Services Agreement (DSA) to provide data processing services to Accordis Holding Corp. (AHC), the purchaser of Accordis, for \$2.7 million per annum (ii) a Sublease Agreement with AHC for the portion of one floor at its headquarters previously occupied by the Accordis business for 18 months at an annual rent of \$0.2 million and (iii) a short-term Transition Services Agreement with AHC to provide accounting and human resource support services at cost through December 31, 2005. As the continuing operations are providing services to Accordis under these agreements, in periods subsequent to August 31, 2005, costs previously attributed to discontinued operations are now presented as part of continuing operations.

Years Ended December 31, 2005 and 2004

Continuing Operations:

The following table sets forth, for the periods indicated, certain items in our Consolidated Statements of Operations expressed as a percentage of revenue:

	Years ended December 31,	
	2005	2004
Revenue	100.0%	100.0%
Cost of services:		
Compensation	44.9%	45.7%
Data processing	8.0%	7.9%
Occupancy	7.8%	8.2%
Direct project costs	16.3%	16.9%
Other operating costs	10.4%	11.1%
Total cost of services	87.4%	89.8%
Operating income	12.6%	10.2%
Net interest income	2.1%	0.6%
Income from continuing operations before income taxes	14.7%	10.8%
Income taxes	-0.8%	-0.2%
Income from continuing operations	13.9%	10.6%
Income from discontinued operations	1.4%	4.8%
Loss on sale of discontinued operations	-1.9%	-
Net income	13.4%	15.4%

Operating Results

Revenue for the year ended December 31, 2005 was \$60.0 million, an increase of \$9.6 million or 19.0% compared to revenue of \$50.5 million in the prior fiscal year ended December 31, 2004.

HMS, which provides third party liability identification and recovery services to state Medicaid agencies and managed care plans, generated revenue of \$51.6 million in 2005, a \$7.6 million or 17.4% increase over the prior year revenue of \$44.0 million. Revenue from state Medicaid agencies increased by \$4.6 million across the comparable client base reflecting specific non-recurring revenue opportunities with certain clients based on their

particular needs, differences in the timing of when client projects were completed in the current year compared to the prior year, and changes in the volume, yields and scope of client projects. Non-recurring revenue opportunities are generally situations where we have an opportunity to earn additional revenue from a client that we do not expect will recur in the current year or that did not exist in the prior year. Included in revenue generated from the comparable client base was \$8.6 million of revenue for a client whose contract has expired. Revenue from this client is expected to continue through the second quarter of 2006. Revenue from new state contracts executed in 2005 is expected to more than offset this revenue reduction in 2006. In addition, \$1.6 million of the revenue increase in 2005 resulted from service expansions for two existing state clients. Finally, revenue from managed care plans in 2005 was \$1.4 million, an increase of \$1.3 million from the prior year revenue. At December 31, 2005, we had 11 managed care plan clients that contributed \$1.0 million of revenue in the last quarter of 2005 out of the total \$1.4 million of managed care revenue for the entire year.

RSG, which provides reimbursement services for hospitals, generated revenue of \$7.5 million in 2005, a \$1.0 million or 16.0% increase from the prior year revenue of \$6.5 million. This growth primarily reflected an increase of \$2.2 million across the comparable client base resulting from the cost report adjudication timetable of the Medicare intermediaries. Additional revenue for the current year included a \$0.3 million increase from the addition of several low volume clients and expansions in the scope of service provided to an existing customer. During the current year, revenue decreased by \$1.5 million related to two contract terminations.

In 2005, we recorded \$0.9 million of revenue from the data processing services performed for Accordis for the four-month period subsequent to the sale of Accordis. On an annualized basis, we anticipate that revenue for these services will be \$2.7 million.

Compensation expense as a percentage of revenue was 44.9% in the current year compared to 45.7% in the prior year and for 2005 was \$26.9 million, an increase of \$3.9 million, or 16.8% from the prior year period expense of \$23.1 million. This dollar increase resulted principally from higher headcount: for the year ended December 31, 2005, we had an average of 310 employees, compared to an average of 270 employees for the year ended December 31, 2004, an increase of 15.0%. Additionally, compensation expense increased due to general increases in compensation rates, the cost of employee benefits and a \$0.6 million separation payment to the Company's Chairman of the Board, which expense will not be recurring in 2006.

Data processing expense as a percentage of revenue was 8.0% in the current fiscal year compared to 7.9% in the prior fiscal year and for 2005 was \$4.8 million, an increase of \$0.8 million or 20.2% compared to the prior year expense of \$4.0 million. The current year increase is primarily due to the cost of increased capacity in our mainframe environment operation driven by increased revenue in the HMS business, together with expenses related to migrating operations from the mainframe environment to a primarily server based platform. At the end of 2005, we purchased and will bring online in early 2006 sufficient mainframe capacity to handle our projected transaction volumes until we complete the server migration project in 2008. Data processing expenses in 2006 are expected to approximate \$6.7 million, a 39.6% increase from 2005 levels.

Occupancy expense as a percentage of revenue was 7.8% in the current year compared to 8.2% in the prior year and for 2005 was \$4.7 million, an increase of \$0.5 million or 12.3% from the prior year expense of \$4.2 million. This net increase principally reflects additional occupancy costs for continuing operations over and above sublease income charged to the new owners of Accordis.

Direct project expense as a percentage of revenue was 16.3% in the current year compared to 16.9% in the prior year and for 2005 was \$9.8 million, an increase of \$1.3 million or 14.7% from the prior fiscal year expense of \$8.5 million. This increase reflects a \$1.1 million increase in expense related to HMS and a \$0.2 million increase in expense related to RSG. The HMS increase resulted from the participation of subcontractors in the delivery of services related to revenue growth. The RSG increase was principally due to \$0.2 million in bad debt expense.

Other operating expenses as a percentage of revenue were 10.4% in the current year compared to 11.1% in the prior year and for 2005 were \$6.2 million, an increase of \$0.6 million or 12.0% compared to the prior year expense of \$5.6 million. This net increase primarily resulted from increased professional fees associated with state and federal procurements and new business development expenses.

Operating income for the year ended December 31, 2005 was \$7.6 million compared to \$5.1 million for the prior year. HMS had an operating profit of \$21.3 million for the year ended December 31, 2005 compared to \$18.7 million in the prior year. The increase in HMS operating profitability largely reflects the increase in revenue partially offset by increased direct costs and compensation expense as discussed above. RSG had an operating margin of \$2.8 million for the year ended December 31, 2005 compared to \$2.6 million for the prior year. Costs associated with data processing and general and administrative expenses were \$17.4 million for the year ended December 31, 2005 compared to \$16.2 million in the prior year. Subsequent to the sale of Accordis, data processing costs that were previously attributable to discontinued operations are allocable to continuing operations and are billed to Accordis.

In 2005 and 2004, our income tax expense principally consisted of an alternative minimum tax liability and state taxes. We recognized decreases in the valuation allowance related to our ability to realize our deferred tax assets of \$2.2 and \$1.4 million for the years ended December 31, 2005 and 2004, respectively, resulting from our utilization of net operating loss carry-forwards (NOLs) to offset taxable income. At December 31, 2005, we had a valuation allowance of \$3.3 million. The sale of Accordis resulted in a capital loss of \$7.4 million, which can be carried forward for five years and produced a deferred tax asset of \$3.0 million. We believe the available objective evidence, principally the capital loss carryforward being utilizable to offset only future capital gains, creates sufficient uncertainty regarding the realizability of its capital loss carryforward, that it is more likely than not, that substantially all of the capital loss carryforward is not realizable. The remaining valuation allowance of \$0.3 million relates to certain state NOLs where the company doesn't operate currently and there is sufficient doubt about the Company's ability to utilize these NOLs, that it is more likely than not that this portion of the state NOLs are not realizable. The Company does not anticipate that valuation allowance will be available in 2006 to reduce tax expense.

Net interest income of \$1.2 million in fiscal year 2005 compared to \$313,000 in the prior year reflects a shift to municipal auction rate securities, an increase in market rates and an overall increase in cash, cash equivalents and short-term investments.

Income from continuing operations was \$8.3 million in the current year compared to \$5.3 million in the prior year. The \$3.0 million increase in income largely reflects the increase in revenue partially offset by increases in operating expenses as discussed above as well as the increase in net interest income.

As more fully discussed in Item 1. Business, and in Note 1(b) and Note 10(b) of the Notes to Consolidated Financial Statements, we reported the results of Accordis as discontinued operations for all periods presented. Loss from discontinued operations in 2005 of \$0.3 million was principally attributable to a \$1.2 million loss on sale that was partially offset by income from Accordis operations prior to the sale of \$0.9 million. In the prior year, Accordis had income from operations of \$2.4 million reflecting a full year of operations.

Years Ended December 31, 2004 and 2003

Continuing Operations:

The following table sets forth, for the periods indicated, certain items in our Consolidated Statements of Operations expressed as a percentage of revenue:

	Years ended December 31,	
	2004	2003
Revenue	100.0%	100.0%
Cost of services:		
Compensation	45.7%	49.5%
Data processing	7.9%	9.0%
Occupancy	8.2%	9.1%
Direct project costs	16.9%	16.9%
Other operating costs	11.1%	11.8%
Restructuring costs	-	0.8%
Total cost of services	89.8%	97.1%
Operating income	10.2%	2.9%
Net interest income	0.6%	0.6%
Income from continuing operations before income taxes	10.8%	3.5%
Income taxes	0.2%	0.1%
Income from continuing operations	10.6%	3.4%
Income from discontinued operations	4.8%	2.0%
Net income	15.4%	5.4%

Revenue for the year ended December 31, 2004 was \$50.5 million, an increase of \$7.6 million or 17.8% compared to revenue of \$42.8 million in the prior fiscal year ended December 31, 2003.

HMS generated revenue of \$44.0 million in 2004, a \$6.9 million or 18.5% increase over the prior year revenue of \$37.1 million. This increase primarily reflected \$1.0 million of revenue during the current year from two new state and one managed health plan clients and \$0.4 million related to the expansion of services for two existing clients. In addition, revenue increased by \$5.5 million across the comparable client base reflecting specific non-recurring revenue opportunities with certain clients based on their particular needs, differences in the timing of when client projects were completed in the current year compared with the prior year, and changes in the volume, yields and scope of client projects. Non-recurring revenue opportunities are generally situations where we have an opportunity to earn additional revenue from a client which we do not expect will recur in the current year or which did not exist in the prior year. There were no client terminations during 2004.

RSG generated revenue of \$6.5 million in 2004, a \$0.7 million or 13.1% increase from the prior year revenue of \$5.7 million. This increase primarily consisted of \$0.7 million of revenue from new customers since the prior year period, \$0.4 million of revenue from scope or facility expansions from existing clients, and a \$0.1 million increase across the comparable client base. Partially offsetting these increases was a \$0.5 decrease in revenue due to a contract expiration.

Compensation expense as a percentage of revenue was 45.7% in 2004 compared to 49.5% in 2003 and for 2004 was \$23.0 million, an increase of \$1.8 million, or 8.7% from the prior year period expense of \$21.2 million. This dollar increase resulted from general increases in compensation rates and the cost of employee benefits. For the

year ended December 31, 2004, we had an average of 270 employees, compared to an average of 251 employees for the year ended at December 31, 2003, an increase of 7.6%.

Data processing expense as a percentage of revenue was 7.9% in 2004 compared to 9.0% in 2003 and for 2004 was \$4.0 million, an increase of \$0.2 million or 4.0% compared to the prior year expense of \$3.8 million. This increase was due to increased software costs.

Occupancy expense as a percentage of revenue was 8.2% in 2004 compared to 9.1% in 2003 and for 2004 was \$4.2 million, an increase of \$0.3 million or 7.1% from the prior year expense of \$3.9 million. This net increase principally reflects space expansion in our Dallas Service Center and various other client service offices.

Direct project expense as a percentage of revenue was 16.9% in both 2004 and 2003 and for 2004 was \$8.5 million, an increase of \$1.3 million or 18.3% from the prior fiscal year expense of \$7.2 million. This increase is consistent with a 17.8% increase in revenue.

Other operating expenses as a percentage of revenue were 11.1% in 2004 compared to 11.8% in the prior year and for 2004 were \$5.6 million, an increase of \$0.5 million or 10.3% compared to the expense in 2003 of \$5.1 million. This net increase resulted from \$0.8 million in expenses for professional fees associated with Sarbanes Oxley Act compliance partially offset by reductions of general corporate legal fees.

There were no restructuring costs in the current year, compared to \$0.4 million in the prior year, reflecting an additional charge associated with an increase in the real estate tax rate on sublet office space.

Operating income for the year ended December 31, 2004 was \$5.1 million compared to \$1.3 million for the prior year. HMS had an operating profit of \$18.7 million for the year ended December 31, 2004 compared to \$15.9 million in the prior year. The increase in HMS operating profitability largely reflects the increase in revenue partially offset by increased direct costs and compensation expense as discussed above. RSG had an operating margin of \$2.6 million for the year ended December 31, 2004 compared to \$2.1 million for the prior year. The increase in RSG operating profitability largely reflects the increase in revenue partially offset by increased compensation and other expenses, partially offset by reductions in direct project expense. Costs associated with data processing and general and administrative expenses were \$16.2 million for the year ended December 31, 2004 compared to \$16.7 million in the prior year. These were primarily savings related from the non-recurring nature of the \$0.4 million in restructuring costs recognized in the year ended December 31, 2003, together with some compensation-related savings.

In 2004, we recognized income tax expense of \$103,000, principally an alternative minimum tax liability resulting from our utilization of existing net operating loss carryforwards to offset current taxable income. In 2003, we recognized \$35,000 in alternative minimum tax liabilities. We have incurred significant taxable losses in prior years. Most of our deferred income tax assets are in the form of net operating loss carry-forwards. A recoverability analysis was performed based on our recent taxable loss history and projections of future taxable operating results.

Net interest income of \$313,000 in fiscal year 2004 compared with \$250,000 in the prior year reflects an increase in market interest rates.

Income from continuing operations was \$5.3 million in 2004 compared with \$1.5 million in the prior year. The \$3.8 million increase in income largely reflects the effects of increased revenue, particularly in our HMS business.

Discontinued Operations

As more fully discussed in Item 1. Business, and Note 1(b) and Note 10(b) of the Notes to Consolidated Financial Statements, we reported the results of Accordis as discontinued operations for all periods presented. Income from discontinued operations increased to \$2.4 million in 2004 from \$0.9 million in the prior year. This increase was principally attributable to the increased revenue. In both periods, the results of discontinued operations

reflect only that portion of corporate overhead directly attributable to Accordis and not a full allocation of corporate overhead. Additionally, in 2003, there was \$0.2 million of income from operations discontinued in 2001.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

Liquidity and Capital Resources

Historically, our principal sources of funds are operations. At December 31, 2005, our cash and cash equivalents and short-term investments and working capital were \$41.1 million and \$52.5 million, respectively. Although we expect that operating cash flows will be a primary source of liquidity, the current significant cash and short term investment balances and working capital position are also fundamental sources of liquidity and capital resource. The current cash and cash equivalents and short term investment balances are more than sufficient to meet our short term funding needs that are not met by operating cash flows. Operating cash flows could be adversely affected by a decrease in demand for our services. Our typical customer relationship, however, usually has a duration of several years, such that we do not expect any current decrease in demand. We estimate that we will purchase approximately \$3.4 million of property and equipment during 2006. The payments due by period for our contractual obligations, consisting principally of facility lease obligations and equipment rental and software license obligations, are as follows (in thousands):

	<u>Total</u>	<u>Less than One Year</u>	<u>2-3 Years</u>	<u>4-5 Years</u>	<u>After 5 years</u>
Operating leases	\$29,705	\$4,990	\$8,087	\$7,395	\$9,233

We have entered into sublease arrangements for some of our facility obligations and expect to receive the following rental receipts (in thousands):

	<u>Total</u>	<u>Less than One Year</u>	<u>2-3 Years</u>	<u>4-5 Years</u>	<u>After 5 years</u>
	\$5,805	\$1,693	\$1,449	\$1,176	\$1,487

For the year ended December 31, 2005, cash provided by operations was \$7.1 million compared with \$6.5 million for the prior year. The current year cash provided by operations of \$7.1 million primarily results from \$8.0 million of net income plus depreciation and amortization charges of \$2.3 million, and an increase in current liabilities of \$2.2 million reduced by an increase in accounts receivable of \$5.5 million. During the current year, cash used in investing activities was \$18.7 million reflecting the net purchase of \$15.0 million in short term investments, purchases of \$5.0 million for property and equipment, and a \$0.6 million investment in software. The current year capital expenditures include approximately \$2.1 million related to increased capacity in our data processing operation that was accelerated into fiscal year 2005 to take advantage of favorable vendor pricing.

Inflation

Historically, inflation has not been a material factor affecting our revenue, and general operating expenses have been subject to normal inflationary pressure. However, our business is labor intensive. Wages and other employee-related expenses increase during periods of inflation and when shortages in the skilled labor market occur. We also have a performance-based bonus plan to foster retention of and to incentivize certain employees.

Item 7A. Quantitative and Qualitative Disclosures About Market Risks

Our holdings of financial instruments consist of municipal auction rate securities at December 31, 2005 and are classified as short-term investments and have contractual maturities between 2030 through 2044. We do not invest in portfolio equity securities or commodities or use financial derivatives for trading purposes. Our investment portfolio represents funds held temporarily, pending use in our business and operations. We manage these funds accordingly. We seek reasonable assuredness of the safety of principal and market liquidity by investing in rated fixed income securities while, at the same time, seeking to achieve a favorable rate of return. Our market risk exposure consists principally of exposure to changes in interest rates. Our holdings are also exposed to the risks of changes in the credit quality of issuers.

The table below presents the historic cost basis, and the fair value for our investment portfolio as of December 31, 2005, and the related weighted average interest rates (in thousands):

	Total Historical Cost	Total Fair Value
Municipal auction rate securities	\$37,500	\$37,500
Average interest rate	4.39%	

Item 8. Financial Statements and Supplementary Data

The information required by Item 8 is found on pages 35 to 52 of this report.

Item 9. Changes in and Disagreements with Independent Registered Public Accounting Firm on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures.

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act) as of December 31, 2005. Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report.

Our principal executive officer and principal accounting officer also participated in an evaluation by our management of any changes in our internal control over financial reporting that occurred during the quarter ended December 31, 2005. That evaluation did not identify any changes that have materially affected, or are likely to materially affect, our internal control over financial reporting.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control — Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 31, 2005.

Our independent auditors, KPMG LLP (KPMG), who have audited and reported on our financial statements, issued a report on our assessment of our internal control over financial reporting and on the effectiveness of our internal control over financial reporting. KPMG's reports are included in this annual report.

Item 9B. Other Information

None.

PART III

Item 10. Directors and Executive Officers of the Registrant

The information required by Item 10 will be included in our Proxy Statement for the 2006 Annual Meeting of Shareholders which will be mailed within 120 days after the close of our year ended December 31, 2005, and is hereby incorporated herein by reference to such Proxy Statement.

Item 11. Executive Compensation

The information required by Item 11 will be included in our Proxy Statement, which will be mailed within 120 days after the close of our year ended December 31, 2005, and is hereby incorporated herein by reference to such Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information required by Item 12 will be included in our Proxy Statement, which will be mailed within 120 days after the close of our year ended December 31, 2005, and is hereby incorporated herein by reference to such Proxy Statement.

Item 13. Certain Relationships and Related Transactions

The information required by Item 13 will be included in our Proxy Statement, which will be mailed within 120 days after the close of our year ended December 31, 2005, and is hereby incorporated herein by reference to such Proxy Statement.

Item 14. Principal Accountant Fees and Services

The information required by Item 14 will be included in our Proxy Statement, which will be mailed within 120 days after the close of our year ended December 31, 2005, and is hereby incorporated herein by reference to such Proxy Statement.

PART IV

Item 15. Exhibits and Financial Statement Schedules

- A. Financial Statements, Financial Statement Schedule and Exhibits
 1. The financial statements are listed in the Index to Consolidated Financial Statements on page 31.
 2. Financial Statement Schedule II – Valuation and Qualifying Accounts is set forth on page 53. All other financial statement schedules have been omitted as they are either not required, not applicable, or the information is otherwise included.
 3. The Exhibits are set forth on the Exhibit Index on page 54.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HMS Holdings Corp.
(Registrant)

By: **/s/ Robert M. Holster**
Robert M. Holster
Chief Executive Officer and Director

Date: March 13, 2006

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signatures</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Robert M. Holster</u> Robert M. Holster	Chief Executive Officer and Director (Principal Executive Officer)	March 13, 2006
<u>/s/ Thomas G. Archbold</u> Thomas G. Archbold	Chief Financial Officer (Principal Financial and Accounting Officer)	March 13, 2006
<u>/s/ Randolph G. Brown</u> Randolph G. Brown	Director	March 13, 2006
<u>/s/ James T. Kelly</u> James T. Kelly	Director	March 13, 2006
<u>/s/ William F. Miller III</u> William F. Miller III	Chairman and Director	March 13, 2006
<u>/s/ William W. Neal</u> William W. Neal	Director	March 13, 2006
<u>/s/ Galen D. Powers</u> Galen D. Powers	Director	March 13, 2006
<u>/s/ Ellen A. Rudnick</u> Ellen A. Rudnick	Director	March 13, 2006
<u>/s/ Richard H. Stowe</u> Richard H. Stowe	Director	March 13, 2006

HMS HOLDINGS CORP. AND SUBSIDIARIES
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
HMS Holdings Corp.:

We have audited the consolidated financial statements of HMS Holdings Corp. and subsidiaries as listed in the accompanying index. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedule as listed in the accompanying index. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of HMS Holdings Corp. and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of HMS Holdings Corp.'s internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 10, 2006 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

/s/ KPMG LLP

New York, New York
March 13, 2006

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
HMS Holdings Corp.:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that HMS Holdings Corp. maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). HMS Holdings Corp.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that HMS Holdings Corp. maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, HMS Holdings Corp. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of HMS Holdings Corp. and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, shareholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2005, and our report dated March 10, 2006 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

New York, New York
March 13, 2006

HMS HOLDINGS CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)
(unaudited)

	December 31, 2005	December 31, 2004
Assets		
Current assets:		
Cash and cash equivalents	\$ 3,641	\$ 9,196
Short-term investments	37,500	22,500
Accounts receivable, net of allowance of \$675 and \$300 at December 31, 2005 and 2004, respectively	19,030	13,544
Prepaid expenses and other current assets, including deferred tax assets of \$3,978 and \$1,981 at December 31, 2005 and 2004, respectively	5,699	3,196
Current assets of discontinued operations	-	10,605
Total current assets	<u>65,870</u>	<u>59,041</u>
Property and equipment, net	7,534	4,183
Goodwill, net	2,382	2,382
Deferred income taxes, net	6,398	6,939
Other assets	5,417	37
Noncurrent assets of discontinued operations	-	4,081
Total assets	<u><u>\$ 87,601</u></u>	<u><u>\$ 76,663</u></u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable, accrued expenses and other liabilities	\$ 13,335	\$ 11,228
Current liabilities of discontinued operations	-	3,666
Total current liabilities	<u>13,335</u>	<u>14,894</u>
Other liabilities	1,497	1,371
Total liabilities	<u>14,832</u>	<u>16,265</u>
Commitments and contingencies		
Shareholders' equity:		
Preferred stock - \$.01 par value; 5,000,000 shares authorized; none issued		
Common stock - \$.01 par value; 45,000,000 shares authorized; 21,874,579 shares issued and 20,211,733 shares outstanding at December 31, 2005; 20,980,331 shares issued and 19,335,415 shares outstanding at December 31, 2004	219	210
Capital in excess of par value	81,681	77,237
Retained earnings (deficit)	266	(7,761)
Treasury stock, at cost; 1,662,846 and 1,644,916 shares at December 31, 2005 and 2004, respectively	<u>(9,397)</u>	<u>(9,288)</u>
Total shareholders' equity	<u>72,769</u>	<u>60,398</u>
Total liabilities and shareholders' equity	<u><u>\$ 87,601</u></u>	<u><u>\$ 76,663</u></u>

See accompanying notes to consolidated financial statements.

HMS HOLDINGS CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except share and per share amounts)

	Year ended December 31, 2005	Year ended December 31, 2004	Year ended December 31, 2003
Revenue	\$ 60,024	\$ 50,451	\$ 42,823
Cost of services:			
Compensation	26,945	23,062	21,216
Data processing	4,793	3,987	3,834
Occupancy	4,670	4,158	3,881
Direct project costs	9,796	8,544	7,224
Other operating costs	6,244	5,576	5,055
Restructuring Costs	-	-	352
Total cost of services	<u>52,448</u>	<u>45,327</u>	<u>41,562</u>
Operating income	7,576	5,124	1,261
Net interest income	<u>1,238</u>	<u>313</u>	<u>250</u>
Income from continuing operations before income taxes	8,814	5,437	1,511
Income taxes	<u>465</u>	<u>103</u>	<u>35</u>
Income from continuing operations	<u>8,349</u>	<u>5,334</u>	<u>1,476</u>
Discontinued operations, net of tax:			
Income from discontinued operations	839	2,377	872
Loss on sale of discontinued operations	<u>(1,161)</u>	<u>-</u>	<u>-</u>
Income (loss) from discontinued operations	<u>(322)</u>	<u>2,377</u>	<u>872</u>
Net income	<u>\$ 8,027</u>	<u>\$ 7,711</u>	<u>\$ 2,348</u>
Basic income per share data:			
Income per share from continuing operations	\$ 0.42	\$ 0.28	\$ 0.08
Income (loss) per share from discontinued operations	<u>(0.02)</u>	<u>0.12</u>	<u>0.05</u>
Net income per basic share	<u>\$ 0.40</u>	<u>\$ 0.40</u>	<u>\$ 0.13</u>
Weighted average common shares outstanding, basic	<u>19,865</u>	<u>19,074</u>	<u>18,330</u>
Diluted income per share data:			
Income per share from continuing operations	\$ 0.37	\$ 0.24	\$ 0.07
Income (loss) per share from discontinued operations	<u>(0.01)</u>	<u>0.11</u>	<u>0.04</u>
Net income per diluted share	<u>\$ 0.36</u>	<u>\$ 0.35</u>	<u>\$ 0.12</u>
Weighted average common shares, diluted	<u>22,287</u>	<u>22,275</u>	<u>20,132</u>

See accompanying notes to consolidated financial statements.

HMS HOLDINGS CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME
(In thousands, except share amounts)

	<u>Common Stock</u>		<u>Capital In Excess Of Par Value</u>	<u>Unearned Stock Compensation</u>	<u>Retained Earnings/ Accumulated Deficit</u>	<u>Accumulated Other Comprehensive Income/(Loss)</u>	<u>Treasury Stock</u>		<u>Note Receivable from Sale of Stock</u>	<u>Total Shareholders' Equity</u>
	<u># of Shares Issued</u>	<u>Par Value</u>					<u># of Shares</u>	<u>Amount</u>		
Balance at December 31, 2002	19,885,390	\$199	\$74,959	(\$33)	(\$17,820)	\$8	1,609,116	(\$9,184)	(\$361)	\$47,768
Comprehensive income:										
Net income	-	-	-	-	2,348	-	-	-	-	2,348
Change in net unrealized appreciation on short-term investments	-	-	-	-	-	(8)	-	-	-	(8)
Total comprehensive income										2,340
Repayment of note receivable	-	-	-	-	-	-	-	-	361	361
Shares issued under employee stock purchase plan	17,380	-	48	-	-	-	-	-	-	48
Exercise of stock options	139,651	1	191	-	-	-	-	-	-	192
Purchase of treasury stock	-	-	-	-	-	-	35,800	(104)	-	(104)
Remeasurement of unearned stock compensation	-	-	(31)	31	-	-	-	-	-	-
Stock compensation expense	-	-	-	2	-	-	-	-	-	2
Balance at December 31, 2003	20,042,421	\$200	\$75,167	\$ -	(\$15,472)	\$ -	1,644,916	(\$9,288)	\$ -	\$50,607
Net and comprehensive income:										
Disqualifying dispositions	-	-	41	-	7,711	-	-	-	-	7,711
Exercise of stock options	937,910	10	2,029	-	-	-	-	-	-	2,039
Balance at December 31, 2004	20,980,331	\$210	\$77,237	\$ -	(\$7,761)	\$ -	1,644,916	(\$9,288)	\$ -	\$60,398
Net and comprehensive income:										
Disqualifying dispositions	-	-	1,456	-	8,027	-	-	-	-	8,027
Exercise of stock options	894,248	9	2,988	-	0	-	-	-	-	1,456
Purchase of treasury stock	-	-	-	-	-	-	17,930	(109)	-	2,997
Balance at December 31, 2005	21,874,579	\$219	\$81,681	\$ -	\$266	\$ -	1,662,846	(\$9,397)	\$ -	\$72,769

See accompanying notes to consolidated financial statements.

HMS HOLDINGS CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Year ended December 31, 2005	Year ended December 31, 2004 Revised	Year ended December 31, 2003 Revised
Operating activities:			
Net income	\$ 8,027	\$ 7,711	\$ 2,348
Adjustments to reconcile net income to net cash provided by operating activities:			
Loss (income) from discontinued operations	322	(2,377)	(837)
Depreciation and amortization	2,319	1,706	2,069
Loss (gain) on disposal and write-off of capitalized software costs and property and equipment	-	9	(65)
Stock compensation expense	-	-	2
Changes in assets and liabilities:			
Increase in accounts receivable	(5,486)	(3,824)	(2,693)
(Increase) decrease in prepaid expenses and other current assets	(338)	139	(2,168)
(Increase) decrease in other assets	(7)	(178)	2,437
Increase (decrease) in accounts payable, accrued expenses and other liabilities	2,232	3,303	(745)
Net cash provided by operating activities	<u>7,069</u>	<u>6,489</u>	<u>348</u>
Investing activities:			
Purchases of short term investments	(72,350)	(35,350)	-
Sales of short term investments	57,350	12,950	1,000
Proceeds from sale of Accordis	2,000	-	-
Purchases of property and equipment	(5,040)	(3,099)	(639)
Investment in software	(630)	(407)	-
Net cash provided by (used in) investing activities	<u>(18,670)</u>	<u>(25,906)</u>	<u>361</u>
Financing activities:			
Proceeds from issuance of common stock	-	-	48
Proceeds from exercise of stock options	2,997	2,080	192
Repayment of note receivable from officer for purchase of common stock	-	-	361
Purchases of treasury stock	(109)	-	(104)
Net cash provided by financing activities	<u>2,888</u>	<u>2,080</u>	<u>497</u>
Net increase (decrease) in cash and cash equivalents	(8,713)	(17,337)	1,206
Cash provided by (used in) discontinued operations			
Cash provided by operating activities	3,385	492	1,397
Cash used in investing activities	(227)	(574)	(162)
Net cash provided by (used in) discontinued operations	<u>3,158</u>	<u>(82)</u>	<u>1,235</u>
Cash and cash equivalents at beginning of period	<u>9,196</u>	<u>26,615</u>	<u>24,174</u>
Cash and cash equivalents at end of period	<u>\$ 3,641</u>	<u>\$ 9,196</u>	<u>\$ 26,615</u>
Supplemental disclosure of cash flow information:			
Cash paid for income taxes	<u>\$ 360</u>	<u>135</u>	<u>8</u>
Supplemental disclosure of noncash investing activities:			
Change in unearned compensation	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (31)</u>
Supplemental disclosure of noncash investing activities:			
Note receivable from the sale of Accordis	<u>\$ 5,542</u>	<u>\$ -</u>	<u>\$ -</u>

See accompanying notes to consolidated financial statements.

HMS HOLDINGS CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

(a) Organization and Business

HMS Holdings Corp. (Holdings or the Company) provides a variety of cost containment and payment accuracy services relating to government healthcare programs. These services are in general designed to help our clients increase revenue and reduce operating and administrative costs. The Company operates two businesses through its wholly owned subsidiaries, Health Management Systems, Inc. (HMS) and Reimbursement Services Group Inc (RSG).

(b) Basis of Presentation and Principles of Consolidation

(i) Discontinued Operations of Business Segment

During 2005, the Company sold its Accordis Inc. (Accordis) subsidiary, which in prior periods had been a separate reportable segment. The historical operating results of Accordis have been reported as discontinued operations in the accompanying Consolidated Statements of Income.

(ii) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

(c) Cash and Cash Equivalents

For purposes of financial reporting, the Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

(d) Short-Term Investments

Short-term investments are recorded at fair value. Debt securities that the Company does not have the intent and ability to hold to maturity are classified either as "available for sale" or as "trading" and are carried at fair value. All of the Company's short-term investments are available for sale and carried at fair value. Unrealized gains and losses on securities classified as available for sale are carried as a separate component of shareholders' equity. Unrealized gains and losses on securities classified as trading are reported in earnings. Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determination at each balance sheet date.

(e) Depreciation and Amortization of Property and Equipment

Property and equipment are recorded at cost. Depreciation is provided over the estimated useful lives of the property and equipment utilizing the straight-line method. Amortization of leasehold improvements is provided over the estimated useful lives of the assets or the terms of the leases, whichever is shorter, using the straight-line method. The estimated useful lives are as follows:

Equipment	3-5 years
Leasehold improvements	5-10 years
Furniture and fixtures	5-7 years

(f) Software Development Cost

The Company capitalizes certain software development costs related to software developed for internal use while in the application development stage. All other costs to develop software for internal use, either in the preliminary project stage or post implementation stage are expensed as incurred. Amortization of software development costs is calculated on a straight-line basis over the expected economic life of the product, generally estimated to be 36-48 months.

(g) Goodwill

Goodwill, representing the excess of acquisition costs over the fair value of net assets of acquired businesses, is not amortized but is reviewed for impairment at least annually and written down only in the periods in which it is determined that the recorded value is greater than its fair value. Fair value is based on a projection of the estimated discounted future net cash flows expected to result from the acquired business, using a discount rate reflective of our cost of funds. For the purposes of performing this impairment test, the Company's business segments are its reporting units. The fair values of the Company's reporting units, to which goodwill has been

HMS HOLDINGS CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

assigned, is compared with their recorded values. If recorded values are less than the fair values, no impairment is indicated. No impairment losses have been recorded in any of the periods presented.

(h) Long-Lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying value of its assets to the estimated undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying value of the assets exceeds the fair value of the assets and would be charged to earnings. Fair value is based on a projection of the estimated discounted future net cash flows expected to result from the asset, using a discount rate reflective of our cost of funds. Assets to be disposed of are reported at the lower of the carrying amount or fair value less the cost to sell.

(i) Income Taxes

Income taxes are accounted for under the asset and liability method. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. This method also requires the recognition of future tax benefits for net operating loss carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized as income in the period that includes the enactment date. The Company provides a valuation allowance to reduce deferred tax assets to its estimated realizable value.

(j) Net Income Per Common Share

Basic income per share is calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted income per share is calculated by dividing net income by the weighted average number of common shares and common stock equivalents outstanding during the period. The Company had weighted average common shares and common stock equivalents outstanding during the years ended December 31, 2005, 2004 and 2003, of 19,865,000, 19,074,000 and 18,330,000, respectively for weighted average common shares, and 2,422,000, 3,201,000 and 1,802,000, respectively for common stock equivalents. The Company's common stock equivalents consist of stock options.

(k) Revenue Recognition

The Company recognizes revenue for its contingency fee based services when third party payors remit payments to the Company's customers and consequently the contingency is deemed to have been satisfied. This revenue recognition policy is specifically addressed in the SEC's "Frequently Asked Questions and Answers" bulletin released on October 12, 2000 pertaining to Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB101). Transaction-related revenue is recognized based upon the completion of those transactions or services rendered during a given period. Non-refundable implementation fees are recognized over the implementation period, generally not exceeding nine months.

In 2003, Staff Accounting Bulletin No. 104, Revenue Recognition (SAB 104) replaced SAB 101. The provisions of SAB 104 related to the Company's revenue recognition policy as discussed above were unchanged from SAB 101.

EITF 00-21, "Revenue Arrangements with Multiple Deliverables," requires contracts with multiple deliverables to be divided into separate units of accounting if certain criteria are met. While EITF 00-21 has not had a material impact on the Company's financial statements, the Company applies the guidance therein and recognizes revenue on multiple deliverables as separate units of accounting if the criteria are met.

HMS HOLDINGS CORP. AND SUBSIDIARIES
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(l) Stock-Based Compensation

The Company accounts for stock-based compensation under Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation." As permitted by SFAS No. 123, the Company has elected to continue following the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and to adopt only the disclosure provisions of SFAS No. 123. Accordingly, no employee compensation costs have been recognized for its stock option plans. Had compensation costs for the Company's stock options been determined consistent with the fair value method prescribed by SFAS 123, the Company's net income (loss) and related per share amounts would have been adjusted to the pro forma amounts indicated below:

<i>(in thousands, except per share amounts)</i>		Year Ended December 31, 2005	Year Ended December 31, 2004	Year Ended December 31, 2003
Net income, as reported		\$ 8,027	\$ 7,711	\$ 2,348
Stock-based employee compensation expense included in reported net income		-	-	-
Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		\$ (2,171)	\$ (1,363)	\$ (2,403)
Pro forma net income (loss)		<u>\$ 5,856</u>	<u>\$ 6,348</u>	<u>\$ (55)</u>
Net income per basic share:	As reported	\$ 0.40	\$ 0.40	\$ 0.13
	Pro forma	\$ 0.29	\$ 0.33	\$ -
Net income per diluted share:	As reported	\$ 0.36	\$ 0.35	\$ 0.12
	Pro forma	\$ 0.26	\$ 0.28	\$ -

The effect presented above by applying the disclosure-only provisions of SFAS 123 may not be representative of the effect in future years.

The weighted average fair value of the stock options granted for the years ended December 31, 2005, 2004, and 2003 were \$3.83, \$3.87, and \$1.69, respectively. The fair value of the stock options granted in the years ended December 31, 2005, 2004 and 2003 is estimated at the grant date using the Black-Scholes option-pricing model with the following assumptions: dividend yield of 0% (the Company does not pay dividends); expected volatility of 58.8%, 62.3%, and 61.1%; a risk-free interest rate of 3.99%, 4.03%, and 3.25%, and expected lives of 5.57, 5.98, and 5.97 years, respectively.

(m) Fair Value of Financial Instruments

The carrying amounts for the Company's cash equivalents, short-term investments, accounts receivable, and accounts payable approximate fair value due to their short-term nature. The fair market value for short-term securities is based on quoted market prices where available.

(n) Comprehensive Income

Other comprehensive income recorded by the Company is comprised of unrealized gains and losses on short-term investments.

(o) Use of Estimates

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reported period. The actual results could differ from those estimates.

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(p) Reclassifications

Certain reclassifications were made to prior year amounts to conform to the current presentation. The Company has separately disclosed the operating, investing and financing portions of the cash flows attributable to its discontinued operations which in prior periods were reported on a combined basis as a single amount.

(q) New Accounting Pronouncement

On December 16, 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"), which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123R supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and amends SFAS No. 95, "Statement of Cash Flows." Generally, the approach in SFAS No. 123R is similar to the approach described in SFAS 123. However, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. SFAS No. 123R must be adopted no later than the first interim or annual period beginning after June 15, 2005.

As permitted by SFAS No. 123, we currently account for share-based payments to employees using APB Opinion No. 25's intrinsic value method and, as such, generally recognize no compensation cost for employee stock options. We will adopt SFAS No. 123R on January 1, 2006 using the modified prospective application option. As a result, the compensation cost for the portion of awards we granted before January 1, 2006 for which the requisite service has not been rendered and that are outstanding as of January 1, 2006 will be recognized as the remaining requisite service is rendered. In addition, the adoption of SFAS No. 123R will require us to change from recognizing the effect of forfeitures as they occur to estimating the number of outstanding instruments for which the requisite service is not expected to be rendered. Accordingly, the adoption of SFAS No. 123R's fair value method will have a significant impact on our results of operations. The impact of the adoption of SFAS No. 123R cannot be determined at this time because it will depend upon levels of share-based payments granted in the future. However had the Company adopted SFAS 123R in prior periods, the impact of that standard would have approximated the impact as described in the disclosure of pro forma net (loss) income and net (loss) income per share pursuant to SFAS No. 123 in Note 1 above.

2. Short-Term Investments

The table below presents the historical cost basis, and the fair value for the Company's investment portfolio at December 31, 2005 and 2004 (in thousands):

	Historical Cost	Fair Value
December 31, 2005: Municipal Auction Rate Securities	\$ 37,500	\$ 37,500
December 31, 2004: Municipal Auction Rate Securities	\$ 22,500	\$ 22,500

The Company's holdings of short-term investments at December 31, 2005 consist of municipal auction rate securities of high credit quality and have contractual maturities between 2015 and 2045. All such instruments are classified as securities available for sale.

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3. Property and Equipment

Property and equipment as of December 31, 2005 and 2004 consisted of the following (in thousands):

	December 31, 2005	December 31, 2004
Equipment	\$ 15,188	\$ 10,694
Leasehold improvements	4,434	4,267
Furniture and fixtures	3,777	3,416
Capitalized software	1,694	1,064
	<u>25,093</u>	<u>19,441</u>
Less accumulated depreciation and amortization	(17,559)	(15,258)
Property and equipment, net	<u>\$ 7,534</u>	<u>\$ 4,183</u>

Depreciation and amortization expense related to property, equipment and software charged to operations for the years ended December 31, 2005, 2004 and 2003, was \$2.3 million, \$1.7 million and \$2.1 million, respectively.

4. Accounts Payable, Accrued Expenses and Other Liabilities

Accounts payable, accrued expenses and other liabilities as of December 31, 2005 and 2004 consisted of the following (in thousands):

	December 31, 2005	December 31, 2004
Accounts payable, trade	\$ 5,162	\$ 3,414
Accrued compensation	4,189	3,062
Accrued direct project costs	1,763	1,751
Accrued lease termination costs	1,161	1,336
Accrued other expenses	1,060	1,665
	<u>\$ 13,335</u>	<u>\$ 11,228</u>

As of December 31, 2005 and 2004, \$1.1 million and \$0.9 million, respectively, were included in other liabilities (long-term) related to the Company's recognizing of rental expenses on the Company's facility leases on a straight-line basis.

5. Income Taxes

The current income tax expense for the periods applicable was allocated as follows (in thousands):

	Year Ended December 31, 2005	Year Ended December 31, 2004	Year Ended December 31, 2003
Federal tax expense	\$ 182	\$ 68	\$ 26
State tax expense	283	35	9
Total tax expense	<u>\$ 465</u>	<u>\$ 103</u>	<u>\$ 35</u>

The current income tax expense in 2005, 2004 and 2003 principally arises from Alternative Minimum Tax requirements and some state income tax provisions.

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A reconciliation of the income tax expense (benefit) calculated using the applicable federal statutory rates to the actual income tax expense (benefit) from continuing operations follows (in thousands):

	Years Ended December 31,					
	2005	%	2004	%	2003	%
Income tax expense:						
Computed at federal statutory rate	\$ 2,997	34.0	\$ 1,849	34.0	\$ 514	34.0
State and local tax expense, net of federal benefit	1,207	13.6	777	11.3	196	12.9
Municipal interest	-	-	-	-	(4)	(0.2)
Decrease in valuation allowance	(3,871)	(42.1)	(2,413)	(41.5)	(895)	(59.2)
Other, net	132	(0.3)	(110)	(1.4)	224	14.8
Total income tax expense	<u>\$ 465</u>	<u>5.2</u>	<u>\$ 103</u>	<u>2.4</u>	<u>\$ 35</u>	<u>2.3</u>

Deferred income taxes are recognized for the future tax consequences of temporary differences between the financial statement and tax bases of assets and liabilities. The tax effect of temporary differences that give rise to a significant portion of the deferred tax assets and deferred tax liabilities at December 31, 2005 and 2004 were as follows (in thousands):

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	December 31, 2005	December 31, 2004
Deferred tax assets:		
Allowance for doubtful accounts	\$ 576	\$ 659
Property and equipment	1,055	916
Restructuring cost	640	723
Goodwill and other intangibles	1,063	1,095
Software	428	534
Federal and state net operating loss carryforwards	5,864	9,195
Capital loss carryforward	3,051	-
Deferred stock compensation	409	417
Deferred rent	468	441
Other	550	669
Total deferred tax assets before valuation allowance	14,104	14,649
Less valuation allowance	(3,338)	(5,557)
Total deferred tax assets after valuation allowance	10,766	9,092
Deferred tax liabilities:		
Capitalized research and development cost	390	172
Total deferred tax liabilities	390	172
Total net deferred tax assets	\$ 10,376	\$ 8,920
Net current deferred tax assets	\$ 3,978	\$ 1,981
Net non-current deferred tax assets	6,398	6,939
Total net deferred tax assets	\$ 10,376	\$ 8,920

At December 31, 2005, the Company had net operating loss carry-forwards of \$11.2 million and \$25.4 million, which are available to offset future federal and state/local taxable income, respectively

The Company recognized decreases in the valuation allowance related to the Company's ability to realize its deferred tax assets of \$2.2, \$1.4 and \$1.2 million for the years ended December 31, 2005, 2004 and 2003, respectively. The Company recognized decreases in the valuation allowance principally resulting from the Company's utilization of net operating loss carry-forwards (NOLs) to offset taxable income. At December 31, 2005, the Company has a valuation allowance of \$3.3 million. The sale of Accordis resulted in a capital loss of \$7.4 million, which can be carried forward for five years and produced a deferred tax asset of \$3.0 million. The Company believes the available objective evidence, principally the capital loss carryforward being utilizable to offset only future capital gains, creates sufficient uncertainty regarding the realizability of its capital loss carryforward, that it is more likely than not, that substantially all of the capital loss carryforward is not realizable. The remaining valuation allowance of \$0.3 million relates to certain state NOLs where the company doesn't currently operate currently and there is sufficient doubt about the Company's ability to utilize these NOLs, that it is more likely than not that this portion of the state NOLs are not realizable. The Company does not anticipate that valuation allowance will be available in 2006 to reduce tax expense.

6. Equity

(a) Treasury Stock

On May 28, 1997, the Board of Directors authorized the Company to repurchase such number of shares of its common stock that have an aggregate purchase price not to exceed \$10 million. The Company is authorized to

HMS HOLDINGS CORP. AND SUBSIDIARIES
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repurchase these shares from time to time on the open market or in negotiated transactions at prices deemed appropriate by the Company. Repurchased shares are deposited in the Company's treasury and used for general corporate purposes. During the year ended December 31, 2005, the Company repurchased a total of 17,930 shares of common stock for \$109,000 at an average price of \$6.04 per share. During the year ended December 31, 2004, the Company did not repurchase any shares of common stock. During the year ended December 31, 2003, the Company repurchased a total of 35,800 shares of common stock for \$104,000 at an average price of \$2.93 per share. Since the inception of the repurchase program in June 1997, the Company has repurchased 1,662,846 shares of common stock at an average price of \$5.65 per share having an aggregate purchase price of \$9.4 million.

(b) Preferred Stock

The Company's certificate of incorporation, as amended, authorizes the issuance of up to 5,000,000 shares of "blank check" preferred stock with such designations, rights and preferences as may be determined by the Company's Board of Directors. As of December 31, 2005 no preferred stock had been issued.

7. Employee Benefit Plan

The Company sponsors a benefit plan to provide retirement benefits for its employees known as the HMS Holdings Corp. 401(k) Plan (the 401(k) Plan). Participants may make voluntary contributions to the 401(k) Plan of up to 60% of their annual base pre-tax compensation not to exceed the federally determined maximum allowable contribution. The 401(k) Plan permits discretionary Company contributions. The Company contributions are not in the form of the Company's common stock and participants are not permitted to invest their contributions in the Company's stock. For the years ended December 31, 2005, 2004 and 2003, the Company contributions to the 401(k) Plan were \$419,000, \$386,000, and \$305,000, respectively.

8. Stock-Based Compensation Plans

(a) 1999 Long-Term Incentive Plan

The Company's 1999 Long-Term Incentive Stock Plan (the Plan), was approved by the Company's shareholders at the Annual Meeting of Shareholders held on March 9, 1999. The primary purposes of the Plan are (i) to promote the interests of the Company and its shareholders by strengthening the Company's ability to attract and retain highly competent individuals to serve as Directors, officers and other key employees and (ii) to provide a means to encourage stock ownership and proprietary interest by such persons. The Plan provides for the grant of (a) options to purchase shares of the Company's common stock at an exercise price no less than 100% of the fair market value of the Company's common stock; (b) stock appreciation rights (SAR) representing the right to receive a payment, in cash, shares of common stock, or a combination thereof, equal to the excess of the fair market value of a specified number of shares of the Company's common stock on the date the SAR is exercised over the fair market value of such shares on the date the SAR was granted; or (c) stock awards made or valued, in whole or in part, by reference to shares of common stock. Options are granted under the Plan with various vesting provisions up to five years, including time based and/or performance based vesting periods. Stock options currently outstanding become exercisable and expire at various dates through April 2014. Options expire ten years after the date of grant. As of December 31, 2005, no SAR's or stock purchase awards had been granted. At the June 4, 2003 Annual Meeting of Shareholders, the shareholders approved an increase in the number of shares of common stock available for issuance under the Plan to 6,251,356 from 4,751,356. The Plan expires in January 2009. As of December 31, 2005, there were approximately 248,000 options available for grant under the Plan.

(b) 1995 Non-Employee Director Stock Option Plan

The Company's 1995 Non-Employee Director Stock Option Plan (the NEDP) was adopted by the Board of Directors on November 30, 1994. Under the NEDP, directors of the Company who are not employees of the Company or its subsidiaries may be granted options to purchase 1,500 shares of common stock of the Company during the fourth quarter of each year commencing with fiscal year 1995. Options for the purchase of up to 112,500 shares of common stock may be granted under the NEDP and the Company will reserve the same number of shares for issuance. The options available for grant are automatically increased to the extent any granted options expire or terminate unexercised. The last awards under the NEDP were in October 2000. As of December 31, 2005 and 2004, 29,250 and 36,000 options were outstanding, respectively. As of December 31, 2005, there were approximately 74,000 options available for grant under the NEDP.

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(c) *Summary of Options*

Presented below is a summary of the Company's options for the years ended December 31, 2005, 2004 and 2003 (in thousands, except per share amounts):

	Year Ended December 31, 2005		Year Ended December 31, 2004		Year Ended December 31, 2003	
	Shares	Weighted average exercise price	Shares	Weighted average exercise price	Shares	Weighted average exercise price
Outstanding at						
beginning of period	5,283	\$2.75	6,336	\$2.65	5,625	\$2.65
Granted	825	6.79	50	2.97	980	2.97
Exercised	(894)	3.35	(938)	1.38	(140)	1.38
Forfeitures	(92)	6.37	(167)	5.05	(129)	5.05
Outstanding at						
end of period	5,122	\$3.24	5,281	\$2.68	6,336	\$2.68
Weighted average fair value of options granted (Black-Scholes)		\$3.24		\$3.87		\$1.69

The following table summarizes information for stock options outstanding at December 31, 2005 (in thousands, except per share data):

Range of exercise prices	Number outstanding as of December 31, 2005	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$1.07	275	4.96	\$1.07	275	\$1.07
1.19-1.27	725	5.24	1.19	725	1.19
1.31-1.74	871	5.10	1.37	871	1.37
2.48	755	6.11	2.48	755	2.48
2.76-3.10	608	7.79	2.96	608	2.96
3.41-4.59	690	6.75	3.58	690	3.58
5.88-6.44	601	5.61	6.39	429	6.37
6.95 - 23.00	597	9.03	7.12	210	7.43
\$1.07 - \$23.00	5,122	6.77	\$3.24	4,563	\$2.68

9. Transactions with Officers and Other Related Parties

(a) *Employment Agreements*

The Company is obligated under three employment agreements with executive officers that provide for salary and benefit continuation in the event of termination without cause, that expire in January 2007, April 2007 and December 2007. Additionally, the Company is obligated under a separation agreement with an executive officer that provides for salary and benefit continuation in the event of termination without cause.

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(b) Related Party Transactions

The Company incurred approximately \$24,000, \$259,000 and \$89,000 for the years ended December 31, 2005, 2004 and 2003, respectively, in fees to a law firm at which one director of the Company is a senior partner. The 2004 amounts include contingent fees of approximately \$235,000 incurred in connection with a litigation related to discontinued operations.

10. Restructurings and Discontinued Operations

(a) Restructurings

In December 2001, the Company recognized a restructuring charge of \$1.8 million consisting of \$1.3 million for facility costs associated with reducing the amount of space the Company occupies at its headquarters in New York City, and \$500,000 for severance costs associated with reducing 20 employees in the information technology and facilities maintenance departments. In December 2002, the Company increased this restructuring charge by \$800,000 for additional facilities costs associated with reducing its New York City office space based on an executed sublease. In December 2003, the Company increased this restructuring charge by \$352,000 reflecting higher than forecasted real estate taxes. As of December 31, 2005 and 2004, \$1.2 million and \$1.3 million respectively, remained as accrued lease termination liabilities.

The following table presents a summary of the activity in accrued liabilities for restructuring charges (in thousands):

	New York Leased Space Reduction
Balance at December 31, 2003	\$1,441
Cash payments	(104)
Balance at December 31, 2004	1,337
Cash payments	(176)
Balance at December 31, 2005	<u>\$1,161</u>

(b) Discontinued Operations of Business Segment

On August 31, 2005, the Company sold the stock of its Accordis to Accordis Holding Corp. (AHC), an unrelated New York based private company, for \$8 million, consisting of cash of \$2 million and an interest bearing five-year promissory note of \$6 million. The note bears interest at 6% per annum and requires semi-annual principal payments of \$100,000, with the balance of \$5.1 million due in a balloon payment on August 31, 2010. Management has discounted this note by \$465,000 using an effective rate of 8%, resulting in the note having a net present value at August 31, 2005 of \$5.5 million. At December 31, 2005, the Company has a Note Receivable from AHC of approximately \$5.5 million with \$0.2 million included as a component of Prepaid and Other Current Assets and \$5.3 million as a component in Non-Current Assets.

The Stock Purchase Agreement (SPA) provided for purchase price adjustments based upon differences between the Tangible Net Worth (TNW) and Net Accounts Receivable (NAR), as defined and specified in the SPA, from March 31, 2005 and the final closing of August 31, 2005. Accordis' NAR at August 31, 2005 was approximately \$0.6 million less than the target in the SPA, resulting in a negative purchase price adjustment. This reduction in NAR was principally the result of cash collections exceeding revenue during the period from March 31, 2005 through August 31, 2005. There was no additional adjustment for TNW.

At August 31, 2005, the Company recorded a loss on the sale of the stock of its Accordis business of approximately \$1.2 million, as follows (in thousands):

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Gross Purchase Price	\$ 8,000
Less: Discount on Note	(465)
Less: Net Accounts Receivable adjustment	(603)
Adjusted net proceeds	<u>6,932</u>
Less: Net assets sold including goodwill of \$3.3 million	<u>(8,016)</u>
Loss on sale before transaction costs	(1,084)
Transaction costs	(93)
Loss on sale	(1,177)
Income tax benefit	16
Net loss on sale	<u><u>\$ (1,161)</u></u>

The net assets of Accordis sold exclude certain liabilities retained by the Company of approximately \$0.6 million, consisting principally of liabilities associated with Accordis customers and former employees. A major client of Accordis has filed a claim against Accordis for certain alleged processing errors in submitting claims on behalf of the client. In connection with the sale of Accordis, the Company agreed to indemnify Accordis and its buyer with respect to this claim. See Note 11 Commitments and Contingencies.

The SPA contains further indemnification provisions pursuant to which the Company agreed to indemnify AHC for liabilities in connection with Accordis that arose prior to the sale of Accordis to AHC on August 31, 2005. AHC agreed to indemnify the Company for liabilities in connection with Accordis that arise after the sale. There is a minimum indemnification claim threshold of \$250,000 that is computed after taking into account any insurance proceeds. The Company's liability under the indemnification provisions of the SPA is capped at the purchase price. The Company is not aware of any potential claims under the indemnification provisions of the SPA.

Concurrent with the sale of Accordis, the Company entered into a three year Data Services Agreement (DSA) to provide data processing services to AHC for \$2.7 million per annum, which is reported as revenue in the Company's financial statements. The DSA contains specific service levels consistent with prior history and provides for revenue increases in the event AHC exceeds certain transaction levels. For the year ended December 31, 2005, the Company recorded \$900,000 of revenue from the DSA. The Company also entered into a Sublease Agreement with AHC for the portion of one floor at its headquarters previously occupied by the Accordis business. The sublease is for 18 months at an annual rent of \$0.2 million that is reported as a reduction of occupancy costs in the Company's financial statements. Additionally, the Company entered into a short-term Transition Services Agreement with AHC to provide accounting and human resource support services through December 31, 2005. This service was provided at cost and is reported as an \$87,000 reduction of compensation expense in the Company's financial statements.

Results of operations from the Accordis discontinued operations for the eight months ended August 31, 2005 and the years ended December 31, 2004 and 2003 were as follows (in thousands):

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	Eight Months Ended August 31, 2005	Year Ended December 31, 2004	Year Ended December 31, 2003
Revenue	\$17,716	\$34,741	\$31,538
Income before income taxes	826	2,389	625
Income tax (expense) benefit	13	(12)	35
Income from discontinued operations	\$839	\$2,377	\$660

Additionally, in 2003, based on the final results of operations, the Company recognized \$212,000 of income from discontinued operations attributable to operations discontinued in 2001.

Assets and liabilities of the Accordis discontinued operations at December 31, 2004 were as follows (in thousands):

	December 31, 2004
Current assets	\$ 10,605
Current liabilities	(3,666)
Net current assets	\$ 6,939
Property and equipment	\$ 740
Goodwill	3,297
Other assets	44
Net noncurrent assets	\$ 4,081

11. Commitments and Contingencies

(a) Legal

A major client of Accordis has filed a claim against Accordis for certain alleged processing errors in submitting claims on behalf of the client. In connection with the sale of Accordis, the Company agreed to indemnify Accordis and its buyer with respect to this claim. The Company believes that the range of loss on this claim is between \$0.7 million and \$3.5 million and a significant portion of the claim may be covered by insurance. The Company has had discussions with the client regarding the claim, but the parties have not yet been able to reach a satisfactory resolution. There can be no assurances that the claim will be settled without material liability to the Company or that insurance will be available to cover the Company's losses. The Company has recorded \$0.7 million as a liability for this claim.

(b) Lease commitments

The Company leases office space, data processing equipment and software licenses under operating leases that expire at various dates through 2013. The lease agreements provide for rent escalations. Rent expense, net of sublease income, for the years ended December 31, 2005, 2004 and 2003, was \$2.3 million, \$2.7 million and \$2.6 million, respectively. Sublease income was \$1.1 million for the years ended December 31, 2005, 2004 and 2003.

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Minimum annual lease payments to be made and sublease payments to be received for each of the next five years ending December 31 and thereafter are as follows (in thousands):

<u>Year</u>	<u>Payments</u>	<u>Sublease Receipts</u>
2006	\$4,990	\$1,693
2007	4,284	878
2008	3,803	571
2009	3,670	582
2010	3,725	594
Thereafter	9,233	1,487
<u>Total</u>	<u>\$ 29,705</u>	<u>\$5,805</u>

12. Segments and Geographical Information

In June 1997, the FASB issued SFAS No. 131, "Disclosures About Segments of An Enterprise and Related Information." SFAS No. 131 established standards for reporting information about operating segments in annual financial statements and in interim financial reports issued to stockholders.

(a) Segment Information

HMS works on behalf of government healthcare programs to contain costs by recovering expenditures that were the responsibility of a third party, or that were paid inappropriately. HMS' clients include state and county Medicaid programs, their managed care plans, state prescription drug programs, child support enforcement agencies, and other public programs. By assisting these agencies in properly accounting for the services they deliver, we also help ensure that they receive the full amount of program funding to which they are entitled.

RSG provides services for hospitals and other healthcare providers in correctly documenting services which qualify for special reimbursement through the Medicare Cost Report and other governmental payment mechanisms.

The Company measures the performance of its operating segments through "Operating Income" as defined in the accompanying Consolidated Statements of Income. Consistent with how the Company manages these businesses, segment operating margin is reported as operating contribution prior to corporate overheads. Corporate overheads, consisting of data processing costs and general and administrative expenses are managed as cost centers servicing multiple operating businesses. Prior year presentations have been reclassified to be consistent with the current year presentation.

HMS HOLDINGS CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(in thousands)	Total HMS Holdings Continuing Operations	RSG	Health Management Systems	Corporate
<u>Year ended December 31, 2005</u>				
Revenue	\$60,024	\$7,514	\$51,610	\$ 900
Operating income	7,576	2,751	21,296	(16,471)
Total assets	87,601	4,762	18,863	63,976
Goodwill	2,382	1,299	1,083	-
Depreciation and amortization	2,319	34	690	1,595
Capital expenditures and software capitalization	5,670	64	1,832	3,774
<u>Year ended December 31, 2004 (Restated)</u>				
Revenue	\$50,451	\$6,475	\$43,976	\$ -
Operating income	5,124	2,641	18,711	(16,228)
Total assets	61,977	3,335	13,964	44,678
Goodwill	2,382	1,299	1,083	-
Depreciation and amortization	1,706	4	521	1,181
Capital expenditures and software capitalization	3,507	11	975	2,521
<u>Year ended December 31, 2003 (Restated)</u>				
Revenue	42,823	5,727	37,096	-
Operating income	1,261	2,116	15,866	(16,721)
Total assets	51,341	2,696	10,299	38,346
Goodwill	2,382	1,299	1,083	-
Depreciation and amortization	2,069	8	1,046	1,015
Capital expenditures and software capitalization	639	3	486	150

Other corporate assets, including cash and cash equivalents, short-term investments, deferred tax assets and corporate data processing assets are shown in the corporate category and do not include the assets of discontinued operations of \$14.7 million and \$11.8 million in 2004 and 2003, respectively. Prior years amounts include reclassifications to conform to the Company's current segmentation. Corporate revenue results from services provided under the DSA with AHC.

(b) Geographic Information

The Company operates within the continental United States.

(c) Major Customers

The Company's largest client is the Florida Agency for Health Care Administration. This client accounted for 15%, 14% and 11% of the Company's total revenue in the years ended December 31, 2005, 2004 and 2003, respectively. The Company provides services to this client pursuant to a contract awarded in November 2001 for a three-year period with a three-year renewal through October 2007. The Company's second largest client is the Ohio Department of Jobs and Family Services. This client accounted for 14%, 14% and 17% of the Company's total revenue in the years ended December 31, 2005, 2004 and 2003, respectively. This contract ended in June 2005, although HMS will continue to provide services to this client through June 2006 under a contract amendment. The company's third largest client is the New Jersey Department of Human Services. This client accounted for 10%, 14% and 10% of the Company's total revenue in the years ended December 31, 2005, 2004 and 2003, respectively. The Company provides services to this client pursuant to a contract awarded in March 2001 for a three-year period with renewals through September 2006. This customer has been a client of the Company since 1985. While we believe that we will be able to replace the revenue from the Ohio Department of Jobs and Family Services contract with revenue from two new customers added in 2005, if we were to lose another major client, our results of operations could be materially effected by the loss of revenue, and we would seek to replace the client with new business.

HMS HOLDINGS CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(d) *Concentration of Revenue*

The clients constituting the Company's ten largest clients change periodically. The concentration of revenue with such clients was 71% of the Company's revenue in each of the years ended December 31, 2005, 2004 and 2003. In many instances, the Company provides its services pursuant to agreements subject to competitive re-procurement. All of these agreements expire between 2006 and 2008. The Company cannot provide assurance that any of these agreements will be renewed and, if renewed, that the fee rates will be equal to those currently in effect.

13. Change in Accounting Principle for Revenue Recognition

The Company adopted Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB 101) for its fiscal year ended October 31, 2000, implementing a change in accounting in regard to revenue generated from clients seeking reimbursement from third-party payors where its fees are contingent upon the client's collections from third parties.

As of October 31, 1999, the Company had unbilled accounts receivable of \$41.7 million related to its prior revenue recognition policy that had not been invoiced to clients because the Company was contractually obligated to invoice the client only after they received payment from the responsible third party payors. Of this amount, the Company subsequently recognized \$0.6 million and \$1.1 million during fiscal years 2004 and 2003, respectively. There are no remaining amounts to be recognized.

14. Quarterly Financial Data (unaudited)

The table below summarizes the Company's unaudited quarterly operating results for its last two fiscal years.

(in thousands, except per share amounts)		First	Second	Third	Fourth
Year ended December 31, 2005		Quarter	Quarter	Quarter	Quarter
Revenue	\$	12,045	\$ 13,316	\$ 17,435	\$ 17,228
Operating income		786	706	3,679	2,405
Income (loss) from discontinued operations, net		(596)	451	(209)	32
Net income		357	1,383	3,598	2,689
Basic net income per share		0.02	0.07	0.18	0.13
Diluted net income per share		0.02	0.06	0.16	0.12
Year ended December 31, 2004					
Revenue	\$	11,556	\$ 12,166	\$ 12,383	\$ 14,346
Operating income		918	439	1,053	2,713
Income (loss) from discontinued operations, net		(1,236)	652	371	2,591
Net income (loss)		(273)	1,142	1,468	5,374
Basic net income (loss) per share		(0.01)	0.06	0.08	0.28
Diluted net income (loss) per share		(0.01)	0.05	0.07	0.24

HMS HOLDINGS CORP. AND SUBSIDIARIES
SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS
(in thousands)

Allowance for doubtful accounts:

Balance, December 31, 2002	\$300
Provision	-
Recoveries	-
Charge-offs	-
Balance, December 31, 2003	<u>300</u>
Provision	-
Recoveries	-
Charge-offs	-
Balance, December 31, 2004	<u>300</u>
Provision	375
Recoveries	-
Charge-offs	-
Balance, December 31, 2005	<u><u>\$675</u></u>

HMS HOLDINGS CORP. AND SUBSIDIARIES
EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Description</u>
2	Agreement and Plan of Merger, dated as of December 16, 2002, among Health Management Systems, Inc., HMS Holdings Corp. and HMS Acquisition Corp. (Incorporated by reference to Exhibit 2.1 to Amendment No. 1 ("Amendment No. 1") to HMS Holdings Corp.'s Registration Statement on Form S-4, File No. 333-100521 (the "Form S-4"))
3.1(i)	Restated Certificate of Incorporation of HMS Holdings Corp. (Incorporated by reference to Exhibit 3.1 to Amendment No. 1)
3.1(ii)	Certificate of Amendment to the Certificate of Incorporation of HMS Holdings Corp. (Incorporated by reference to Exhibit 3.1(a) to HMS Holdings Corp.'s Registration Statement on Form S-8, File No. 333-108436 (the "1999 Plan Form S-8"))
3.2	By-laws of HMS Holdings Corp. (Incorporated by reference to Exhibit 3.2 to the Form S-4)
10.1	Health Management Systems, Inc. Employee Stock Purchase Plan, as amended (Incorporated by reference to Exhibit 10.2 to the January 1994 Form 10-Q and to Exhibit 10.1 to Health Management Systems, Inc.'s Quarterly Report on Form 10-Q for the quarter ended January 31, 1995 (the "January 1995 Form 10-Q"))
10.2	Health Management Systems, Inc. 1995 Non-Employee Director Stock Option Plan (Incorporated by reference to Exhibit 10.2 to the January 1995 Form 10-Q)
10.3	HMS Holdings Corp. 1999 Long-Term Incentive Stock Plan (Incorporated by reference to Exhibit 4 to the 1999 Plan Form S-8)
10.3(i)	Form of Incentive Stock Option Agreement (Incorporated by reference to Exhibit 10.1 to HMS Holdings Corp.'s Current Report on Form 8-K dated December 14, 2004 (the "December 2004 Form 8-K"))
10.3(ii)	Form of Non-Qualified Stock Option Agreement (Incorporated by reference to Exhibit 10.2 to the December 2004 Form 8-K)
10.4(i)	Employment Agreement, dated as of October 2, 2000, between Health Management Systems, Inc. and William F. Miller III (Incorporated by reference to Exhibit 10.17(i) to Health Management Systems, Inc.'s Annual Report on Form 10-K for the year ended October 31, 2000 (the "2000 Form 10-K"))
10.4(ii)	Amendment, dated as of November 4, 2003, to Employment Agreement between HMS Holdings Corp. and William F. Miller III
10.4(iii)	Amended and Restated Employment Agreement, date as of December 31, 2005, between HMS Holdings Corp. and William F. Miller II (Incorporated by reference to Exhibit 99.1 to HMS Holdings Corp.'s Current Report on Form 8-K dated January 18, 2006 (the "January 2006 Form 8-K"))
10.5	Restricted Stock Purchase Agreement for 550,000 Common Shares dated January 10, 2001, between Health Management Systems, Inc. and William F. Miller III (Incorporated by reference to Exhibit 10.17(ii) to the 2000 Form 10-K)
10.6	Pledge Agreement, dated January 10, 2001, between Accelerated Claims Processing, Inc. and William F. Miller III (Incorporated by reference to Exhibit 10.17(iii) to the 2000 Form 10-K)
10.7	Promissory note, dated January 10, 2001, in the principal amount of \$721,875 between William F. Miller III and Accelerated Claims Processing, Inc. (Incorporated by reference to Exhibit 10.17(iv) to the 2000 Form 10-K)
10.8(i)	Employment Agreement dated as of March 30, 2001 by and between Health Management Systems, Inc. and Robert M. Holster (Incorporated by reference to Exhibit 10.2(i) to Health Management Systems, Inc.'s Quarterly Report on Form 10-Q for the quarter ended April 30, 2001 (the "April 2001 Form 10-Q"))

HMS HOLDINGS CORP. AND SUBSIDIARIES
EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Description</u>
10.8(ii)	Amendment dated as of February 11, 2004 to Employment Agreement between HMS Holdings Corp. and Robert M. Holster (Incorporated by reference to Exhibit 10 to HMS Holdings Corp.'s Quarterly Report on Form 10-Q for the quarter ended March 31, 2004)
10.9	Stock Option Agreement dated as of March 30, 2001 by and between Health Management Systems, Inc. and Robert M. Holster (Incorporated by reference to Exhibit 10.2(ii) to the April 2001 Form 10-Q)
10.10	Employment Agreement dated as of January 1, 2003 by and between Health Management Systems, Inc. and William C. Lucia (Incorporated by reference to Exhibit 10.13 to HMS Holdings Corp.'s Annual Report on Form 10-K for the year ended December 31, 2002 (the "2002 Form 10-K"))
10.10(1)	Amendment, dated as of December 31, 2005, to Employment Agreement between William C. Lucia and HMS Holdings Corp. (Incorporated by reference to Exhibit 99.2 to the January 2006 Form 8-K). (
10.11	Separation Agreement, dated as of December 31, 2005, between Thomas G. Archbold and HMS Holdings Corp. (Incorporated by reference to Exhibit 99.3 to the January 2006 Form 8-K).
10.12(i)	Leases, dated September 24, 1981, September 24, 1982, and January 6, 1986, as amended, between 401 Park Avenue South Associates and Health Management Systems, Inc. (Incorporated by reference to Exhibit 10.13 to Health Management Systems, Inc.'s Registration Statement on Form S-1, File No. 33-46446, dated June 9, 1992 and to Exhibit 10.5 to Health Management Systems, Inc.'s Quarterly Report on Form 10-Q for the quarter ended January 31, 1994)
10.12(ii)	Lease, dated as of March 15, 1996, by and between 387 PAS Enterprises, as Landlord, and Health Management Systems, Inc., as Tenant (Incorporated by reference to Exhibit 10.2 to Health Management Systems, Inc.'s Quarterly Report on Form 10-Q for the quarter ended July 31, 1996 (the "July 1996 Form 10-Q"))
10.12(iii)	Fifth Amendment, dated May 30, 2000 to the lease for the entire eighth, ninth, and tenth floors and part of the eleventh and twelfth floor between 401 Park Avenue South Associates, LLC and Health Management Systems, Inc. (Incorporated by reference to Exhibit 10.1 to Health Management Systems, Inc.'s Quarterly Report on Form 10-Q for the quarter ended July 31, 2000 (the "July 2000 Form 10-Q"))
10.12(iv)	Sixth Amendment, dated May 1, 2000 to the lease for the entire eighth, ninth, and tenth floors and part of the eleventh and twelfth floor between 401 Park Avenue South Associates, LLC and Health Management Systems, Inc. Tenant (Incorporated by reference to Exhibit 10.2 to the July 2000 Form 10-Q)
10.12(v)	Seventh Amendment, dated April 1, 2001 to the lease for the entire eighth, ninth, and tenth floors and part of the eleventh floor between 401 Park Avenue South Associates, LLC and Health Management Systems, Inc. Tenant (Incorporated by reference to Exhibit 10.1(v) to the April 2001 Form 10-Q)
10.12(vi)	Third Amendment, dated May 30, 2000 to the lease for a portion of the eleventh floor between 401 Park Avenue South Associates, LLC and Health Management Systems, Inc. (Incorporated by reference to Exhibit 10.3 to the July 2000 Form 10-Q)
10.12(vii)	Fourth Amendment, dated May 1, 2000 to the lease for a portion of the eleventh floor between 401 Park Avenue South Associates, LLC and Health Management Systems, Inc. (Incorporated by reference to Exhibit 10.4 to the July 2000 Form 10-Q)
10.12(viii)	Fifth Amendment, dated May 1, 2003 to the lease for a portion of the eleventh floor between 401 Park Avenue South Associates, LLC and Health Management Systems, Inc. (Incorporated by reference to Exhibit 10.1(vi) to

HMS HOLDINGS CORP. AND SUBSIDIARIES
EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Description</u>
	the April 2001 Form 10-Q)
10.12(ix)	Fifth Amendment, dated May 30, 2000 to the lease for the fourth floor and the penthouse between 401 Park Avenue South Associates, LLC and Health Management Systems, Inc. (Incorporated by reference to Exhibit 10.7 to the July 2000 Form 10-Q)
10.12(x)	Sixth Amendment, dated May 1, 2000 to the lease for the fourth floor and the penthouse between 401 Park Avenue South Associates, LLC and Health Management Systems, Inc. (Incorporated by reference to Exhibit 10.8 to the July 2000 Form 10-Q)
10.12(xi)	Seventh Amendment, dated March 1, 2001 to the lease for the fourth floor and the penthouse between 401 Park Avenue South Associates, LLC and Health Management Systems, Inc. (Incorporated by reference to Exhibit 10.1(iv) to the April 2001 Form 10-Q)
10.13(i)	Sublease Agreement, dated December 23, 1997, between Health Management Systems, Inc. and Shandwick USA, Inc. (Incorporated by reference to Exhibit 10.1 to Health Management Systems, Inc.'s Quarterly Report on Form 10-Q for the quarter ended January 31, 1998 (the "January 1998 Form 10-Q"))
10.13(ii)	Consent to Sublease, dated December 23, 1997, by 387 P.A.S. Enterprises to the subletting by Health Management Systems, Inc. to Shandwick USA, Inc. (Incorporated by reference to Exhibit 10.2 to the January 1998 Form 10-Q)
10.14	Sublease Agreement, dated as of January 2003, between Health Management Systems, Inc. and Vitech Systems Group, Inc. (Incorporated by reference to Exhibit 10.17 to the 2002 Form 10-K)
10.15	Settlement Agreement and Release dated February 3, 2005 between the District of Columbia and Health Management Systems, Inc.
10.16	Data Services Agreement, dated August 31, 2005, between HMS Business Services, Inc. ("Vendor") and Accordis Holding Corp. (Incorporated by reference to Exhibit 99.3 to HMS Holdings Corp.'s Current Report on Form 8-K dated August 31, 2005 (the "August 2005 Form 8-K")).
10.17	Accordis Holding Corp. Subordinated Promissory Note dated August 31, 2005 (Incorporated by reference to Exhibit 99.4 to the August 2005 Form 8-K).
10.18	NON-COMPETE AGREEMENT, dated as of August 31, 2005, among HMS HOLDINGS CORP., a New York corporation ("Seller"), HEALTH MANAGEMENT SYSTEMS, INC., a New York corporation ("HMS"), HMS BUSINESS SERVICES, INC., a New York corporation ("HMSBS" and, together with Seller and HMS, the "Seller Entities"), ACCORDIS HOLDING CORP., a New York corporation ("Purchaser"), and ACCORDIS INC., a New York corporation ("Accordis") ((Incorporated by reference to Exhibit 99.5 to the August 2005 Form 8-K).
10.19	Sublease Agreement made as of the 31 st day of August, 2005 between Health Management Systems, Inc., a New York corporation, having its offices at 401 Park Avenue South, 10 th floor, New York, New York 10016 ("Sublandlord"), and Accordis, Inc., a Delaware corporation, having its offices at 401 Park Avenue South, 8 th Floor, New York, New York 10016 ("Subtenant") (Incorporated by reference to Exhibit 99.6 to the August 2005 Form 8-K).
10.20	TRANSITION SERVICES AGREEMENT, dated August 31, 2005, between HMS BUSINESS SERVICES, INC., a New York corporation ("HMS"), and ACCORDIS INC., a New York corporation ("Accordis") (Incorporated by reference to Exhibit 99.7 to the August 2005 Form 8-K).
10.21	SUBCONTRACTING AGREEMENT, made the 31 st day of August 2005, by and between Accordis Inc., a New York corporation ("Accordis"), and Reimbursement Services Group Inc. ("RSG"), a New York corporation (Incorporated by reference to Exhibit 99.8 to the August 2005 Form 8-K).

HMS HOLDINGS CORP. AND SUBSIDIARIES
EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Description</u>
10.22	SOFTWARE LICENSE AGREEMENT ("License"), dated as of August 31, 2005 between Accordis, Inc. ("Licensor") and Health Management Systems, Inc. ("Licensee") (Incorporated by reference to Exhibit 99.9 to the August 2005 Form 8-K).
10.23	Stock Purchase Agreement, dated August 31, 2005 (the "Agreement"), between HMS Holdings Corp., a New York corporation ("Seller"), and Accordis Holding Corp., a New York corporation ("Purchaser") (Incorporated by reference to Exhibit 99.2 to HMS Holdings Corp.'s Current Report on Form 8-K/A dated August 31, 2005).
*21	List of Subsidiaries of HMS Holdings Corp.
*23	Consent of Independent Registered Public Accounting Firm
*31.1	Rule 13a-14(a)/15d-14(a) Certification of the Principal Executive Officer of HMS Holdings Corp.
*31.2	Rule 13a-14(a)/15d-14(a) Certification of the Principal Financial Officer of HMS Holdings Corp.
*32.1	Section 1350 Certification of the Principal Executive Officer of HMS Holdings Corp. The information contained in this Exhibit shall not be deemed filed with the Securities and Exchange Commission nor incorporated by reference in any registration statement filed by the registrant under the Securities Act of 1933, as amended.
*32.2	Section 1350 Certification of the Principal Financial Officer of HMS Holdings Corp. The information contained in this Exhibit shall not be deemed filed with the Securities and Exchange Commission nor incorporated by reference in any registration statement filed by the registrant under the Securities Act of 1933, as amended.

* Filed herewith.

HMS HOLDINGS CORP.

LIST OF SUBSIDIARIES

<u>Subsidiary</u>	<u>State Of Incorporation</u>
Health Management Systems, Inc. 401 Park Avenue South New York, NY 10016	New York
HMS Business Services Inc. 401 Park Avenue South New York, NY 10016	New York
Reimbursement Services Group Inc..... 401 Park Avenue South New York, NY 10016	New York

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
HMS Holdings Corp.:

We consent to the incorporation by reference in the registration statement (Nos. 333-108436, 333-108445 and 033-95326-99) on Form S-8 of HMS Holdings Corp. of our reports dated March 10, 2006, with respect to the consolidated balance sheets of HMS Holdings Corp. and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, shareholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2005, and the related financial statement schedule, management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2005 and the effectiveness of internal control over financial reporting as of December 31, 2005, which reports appear in the December 31, 2005 annual report on Form 10-K of HMS Holdings Corp.

/s/ KPMG LLP

New York, New York
March 10, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-K

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2006

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission File Number: 0-50194

HMS HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

New York
(State or other jurisdiction of
incorporation or organization)

11-3656261
(I.R.S. Employer
Identification No.)

401 Park Avenue South, New York, New York
(Address of principal executive offices)

10016
(Zip Code)

(212) 725-7965

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 of the Act.

☐

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes ☐ No ☒

Aggregate market value of voting stock held by non-affiliates as of June 30, 2006 was \$235 million.

The approximate aggregate market value of the registrant's common stock, \$0.01 par value, held by non-affiliates (based on the last reported sales price on the Nasdaq Stock Market) was \$_____ million at March 7, 2007.

The number of shares common stock, \$0.01 par value, outstanding as of March 7, 2007 was 23,428,011.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Annual Meeting of Shareholders to be filed pursuant to Regulation 14A on or before April 30, 2007 are incorporated in Part III of this report.

HMS HOLDINGS CORP. AND SUBSIDIARIES

ANNUAL REPORT ON FORM 10-K

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Special Note Regarding Forward-Looking Statements

This Annual Report on Form 10-K contains “forward-looking” statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. For this purpose any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words “believes,” “anticipates,” “plans,” “expects” and similar expressions are intended to identify forward-looking statements. These statements involve unknown risks, uncertainties and other factors, which may cause our actual results to differ materially, from those implied by the forward looking statements. Among the important factors that could cause actual results to differ materially from those indicated by such forward-looking statements include those risks identified in “Item 1A –Risk Factors” and other risks identified in this Form 10-K and presented elsewhere by management from time to time. Such forward-looking statements represent management’s current expectations and are inherently uncertain. Investors are warned that actual results may differ from management’s expectations.

PART I

Item 1. Business

Overview

HMS Holdings Corp. (Holdings or the Company) provides a variety of cost avoidance, coordination of benefits, and program integrity services to government healthcare programs. These services help customers recover amounts due from third parties, reduce costs, and ensure regulatory compliance. They are offered through our Health Management Systems, Inc. (HMS) subsidiary.

HMS’s customers are State Medicaid agencies, government-sponsored managed care plans, child support agencies, the Veterans Health Administration, and other public programs. We help these programs contain healthcare costs by identifying third party insurance coverage and recovering expenditures that were the responsibility of the third party, or that were paid in error. The identification of other insurance coverage also helps these programs to avoid future expenditures.

In September 2006, the Company acquired a competitor, the Benefits Solutions Practice Area (BSPA) of Public Consulting Group, Inc. The transaction increased the size of the Company’s business by approximately 70%.

The Healthcare Environment

In 2006, the nation’s healthcare reimbursement system continued to grow more complex, creating new regulatory and economic pressures for healthcare payors and providers. Such complexity is derived in part from the way in which government healthcare programs are organized in the United States. Medicare, the healthcare program for the elderly, is administered by the Centers for Medicare and Medicaid Services (CMS), an agency of the U.S. Department of Health and Human Services. Medicaid, the program that provides medical assistance to eligible needy persons, is regulated by CMS but administered by state healthcare agencies. Many beneficiaries of both Medicare and Medicaid are enrolled in managed care plans, which have the responsibility for both patient care and claim adjudication. The specific requirements and protocols for reimbursement differ among fiscal agents (who process claims for reimbursement) and among states. In addition, health insurance companies and self-insured employers have their own procedures for claim reimbursement, which differ from state to state and region to region. The result is a continually evolving and expanding maze of requirements for healthcare reimbursement.

Within Medicare, the implementation of the Part D prescription drug benefit in 2006 confronted state healthcare agencies with new costs and responsibilities. The benefit added additional payors to the types of entities that cover healthcare costs and overlaid a complex coinsurance formula on pharmacy claims.

As government healthcare programs expand, there is increased pressure at the state and federal level to contain costs. Government healthcare spending, including Medicare and Medicaid, grew at twice the rate of the broader economy in 2006. A variety of legislation has sought to ensure efficient and effective government healthcare spending at both the Federal and state levels.

The Medicare Modernization Act of 2003 (Section 306) directs the secretary of the U.S. Department of Health and Human Services to demonstrate the use of Recovery Audit Contracts (RACs) under the Medicare Integrity Program in identifying underpayments and overpayments, and recouping overpayments under the Medicare program.

The Deficit Reduction Act (DRA), signed into law in February 2006, established a new Medicaid Integrity Program to increase the government's capacity to prevent, detect, and address fraud and abuse in Medicaid program. It is seen as the most significant single dedicated investment the federal government has made in ensuring the integrity of the program.

Under the Social Security Act (Act), States are required to take all reasonable measures to ascertain the legal liability of "third parties" for healthcare services provided to Medicaid recipients. The recent DRA added new entities—self-insured plans, pharmacy benefits managers (PBMs) and other "legally responsible" parties—to the list of entities subject to the provisions of the Act. CMS has agreed to provide guidance to states on when they must have laws in place to implement DRA requirements for third party liability, and to determine exactly which entities are required to provide states with coverage and other data.

Principal Products and Services

The demand for HMS' services arises from the small but significant percentage of government funds spent in error, where either another payor was actually responsible for the service, or a mistake was made in applying complex claim processing rules. Our services focus on containing costs by reducing error rates.

For example, Medicaid is by law the "payor of last resort" for low-income Americans, designed to cover the cost of care that other healthcare benefits do not. It is for this reason that the Federal government requires that states attempt to recover payments made on behalf of beneficiaries with other health insurance. Since 1985, the Company has provided state Medicaid agencies with services to identify the other parties with liability for Medicaid claims, and more recently, has provided these services to Medicaid health plans.

The Company's services draw upon its proprietary information management and data mining techniques, and include coordination of benefits, cost avoidance, and program integrity. In 2006, the Company recovered more than \$1 billion dollars for its clients, and with the data provided to clients, prevented the expenditure of several billion more.

- **Coordination of benefits** services route claims already paid by a government program to the liable third party, which then reimburses the government payor. State Medicaid programs, Medicare, the Veterans Health Administration, and child support agencies must all coordinate benefits with other payors to ensure the appropriate administration of funds. By properly coordinating benefits, these programs are able to recover dollars spent in error and avoid future costs.
- **Cost avoidance** services provide validated insurance coverage information that is used by government payors to reject claims that are the responsibility of a third party, typically a group health plan sponsored by a beneficiary's employer. With verified insurance information, healthcare payors can avoid future costs.

- **Program integrity** services are designed to review claims paid by government programs, identify payments errors, and then recoup the erroneous payments. The Company assists States in ensuring integrity and accuracy of medical and pharmacy claims through audits, data mining, clinical review, repricing, and recoupment services.
- The **Reimbursement Services Group** (RSG) of Holdings provides Medicare bad debt cost reporting and Disproportionate Share claiming services to healthcare providers.

To perform its services, the Company aggregates medical claim, health insurance and other data for beneficiaries from a variety of sources. The data is mined to identify instances of health insurance coverage, or claims that were paid in error for administrative or clinical reasons. The Company provides its clients with ways to recover funds or avoid future errors, including providing validated primary insurance coverage, generating electronic claims to liable third parties, documenting liens that attach to personal injury litigation and estates, and enrolling children under the insurance of non-custodial and custodial parents.

Customers

A majority of the Company's customers are State Medicaid agencies and other state-administered programs. In 2006, the Company also increased its penetration into the Medicaid managed care market, as states increased their use of contracted health plans. At the conclusion of 2006, the Company served 40 State Medicaid agencies and 19 Medicaid health plans.

HMS also provides coordination of benefits and third party insurance identification services to the 21 Veterans Integrated Service Networks (VISNs) of the Veterans Health Administration, and child support agencies in 15 states.

In most cases, customers pay HMS contingency fees calculated as a percentage of the amounts recovered, or fixed fees for cost avoidance data. Most contracts have terms of three to four years.

The Company's largest client is the Florida Agency for Health Care Administration. This client accounted for 11%, 15%, and 14% of the Company's total revenue in the years ended December 31, 2006, 2005, and 2004, respectively. The Company provides services to this client pursuant to a contract awarded in November 2001 for a three-year period, with a three-year renewal through October 2007. The Company's second largest client is the New Jersey Department of Human Services. This client accounted for 11%, 10%, and 14% of the Company's total revenue in the years ended December 31, 2006, 2005, and 2004, respectively. The Company provides services to this client pursuant to a contract awarded in March 2001 for a three-year period, with renewals through February 2007. This customer has been a client of the Company since 1985. The loss of either one of these contracts would have a material impact upon the Company's financial position or results of operations.

The clients constituting our ten largest clients change periodically. The concentration of revenue in such accounts was 51%, 71% and 71% of our revenue in the fiscal years ended December 31, 2006, 2005, and 2004, respectively. In many instances, we provide our services pursuant to agreements subject to competitive re-procurement. All of these agreements expire between 2007 and 2010. We cannot provide any assurance that any of these agreements will be renewed and, if renewed, that the fee rates will be equal to those currently in effect.

Market Trends/Opportunities

Containing healthcare expenditures presents challenges for government due to the number and variety of programs at the state and federal level, the government appropriations process, and the rise in the cost of care and number of beneficiaries. While total U.S. healthcare spending slowed for the third consecutive year in 2005, rising 6.9% compared to 7.2% in 2004, spending reached nearly \$2 trillion, and accounted for 16% of gross domestic product. Medicaid and Medicare spending in particular is fueling this growth. Together, these entitlement programs cost the U.S. more than \$655 billion in 2005, and their expenditure growth outpaced that of other public and private

programs. Moreover, the growth is expected to accelerate. Medicare's prescription drug benefit, introduced in January 2006, increased the program's share of the nations' prescription-drug spending to 22% in 2006 from 2% in 2005 .

Costs for Medicaid—the single largest and fastest-rising expenditure for state government—have been rising steadily for several years. In fiscal year 2007, Medicaid spending is projected to grow by 5%, up from 2.8% in 2006. Medicaid continues to be a major budget issue for states. According to The Fiscal Survey of States published in December 2006 by the National Governors Association and the National Association of State Budget Officers, Medicaid expenditures increased by 7.7% in fiscal 2006, while federal funds increased by 2.9%.

A report issued in September 2006 by the Government Accountability Office estimates that on average 13% of Medicaid beneficiaries have private health insurance coverage at some time during their Medicaid enrollment, exceeding previous estimates. For a healthcare system as large as our nation's, this represents a significant opportunity.

Finally, both the Federal government and a number of states, including California, Massachusetts, and Pennsylvania, have put forth health reform proposals aimed at containing healthcare costs while providing healthcare coverage to the uninsured. In addition, the new Democratic Congress is setting an ambitious healthcare agenda as they look to expand State Children's Health Insurance Programs (S-CHIP) nationwide.

Competition

In addition to the States themselves, which may elect to perform coordination of benefits and cost avoidance functions in-house, HMS competes primarily with large business outsourcing and technology firms, and with small regional firms specializing in one or more of our services. Against these competitors, the Company typically succeeds on the basis of its leadership position in the marketplace, extensive benefit eligibility database, proprietary systems and processes, existing relationships, and pricing.

Business Strategy

Over the course of 2007, the Company expects to grow its business through a number of strategic initiatives.

Ride organic growth. HMS will continue to tap demand for its services created by the steadily increasing expenditures of government-funded healthcare, including in the managed care arena as greater portions of the Medicaid and Medicare population enroll in contracted, risk-bearing health plans or prescription drug plans.

Strengthen regulatory framework. HMS will take advantage of congressional and state legislation reinforcing the ability of government agencies to secure health insurance information from health insurers.

Expand scope. HMS will actively solicit existing clients for additional processing scope, extending its reach to new services and claim types, and earlier access to claim data.

Increase yield. We will implement new technology and processes to improve the quality of data we secure from carriers and providers, enabling us to increase recovery rates on claims we submit for clients. As states enact legislation to implement DRA regulations, the Company will work with its Medicaid clients to make full use of their new cost recovery powers in order to further increase yield.

Add new clients. The Company will continue to market to additional programs, including S-CHIPip, Medicaid managed care plans, and Medicare Advantage Plans.

Add New Services. Where opportunities exist, the Company will continue to add services closely related to cost containment through internal development and/or acquisition.

Employees

As of December 31, 2006, we had 578 employees. No employees are covered by a collective bargaining agreement or are represented by a labor union. We believe our relations with our employees are good.

Financial Information About Industry Segments

Specific financial information with respect to our industry segments is provided in Note 16, Segments and Geographical Information, of the Notes to Consolidated Financial Statements.

Available Information

We maintain a website that contains various information about us and our services. It is accessible at www.hmsholdings.com. Through our website, shareholders and the general public may access free of charge (other than any connection charges from Internet service providers) filings we make with the Securities and Exchange Commission (SEC) as soon as practicable after filing. Filing accessibility in this manner includes the Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, current reports on Form 8-K and Proxy Statements. Additionally, our corporate governance materials, including the charters of the Audit, Compensation and Compliance Committees; and the code of ethical behavior may also be found under the "Company Overview/Corporate Governance" section of our web site. We make no provisions for waivers of the code of ethical behavior. A copy of the foregoing corporate governance materials is available upon written request.

Item 1A. Risk Factors

PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 SAFE HARBOR COMPLIANCE STATEMENT FOR FORWARD-LOOKING STATEMENTS

In passing the Private Securities Litigation Reform Act of 1995 (the Reform Act), Congress encouraged public companies to make "forward-looking statements" by creating a safe harbor to protect companies from securities law liability in connection with forward-looking statements. We intend to qualify both our written and oral forward-looking statements for protection under the Reform Act and any other similar safe harbor provisions.

"Forward-looking statements" are defined by the Reform Act. Generally, forward-looking statements include expressed expectations of future events and the assumptions on which the expressed expectations are based. All forward-looking statements are inherently uncertain as they are based on various expectations and assumptions concerning future events and they are subject to numerous known and unknown risks and uncertainties which could cause actual events or results to differ materially from those projected. Due to those uncertainties and risks, prospective investors are urged not to place undue reliance on written or oral forward-looking statements of the Company. We undertake no obligation to update or revise this safe harbor compliance statement for forward-looking statements to reflect future developments. In addition, we undertake no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes to future operating results over time.

We provide the following risk factor disclosures in connection with our continuing effort to qualify our written and oral forward-looking statements for the safe harbor protection of the Reform Act and any other similar safe harbor provisions. Important factors currently known to management that could cause actual results to differ materially from those in forward-looking statements include the following:

Our Operating Results Are Subject To Significant Fluctuations Due To Variability In The Timing Of When We Recognize Contingency Fee Revenue And Other Factors. As A Result, You Will Not Be Able To Rely On Our Operating Results In Any Particular Period As An Indication Of Our Future Performance.

Our revenue and consequently our operating results may vary significantly from period to period as a result of a number of factors, including the loss of customers, fluctuations in sales activity given our sales cycle of approximately three to eighteen months, and general economic conditions as they affect healthcare providers and payors. Further, we have experienced fluctuations in our revenue of up to 25% between reporting periods due to the timing of periodic revenue recovery projects and the timing and delays in third-party payors' adjudication of claims and ultimate payment to our clients where our fees are contingent upon such collections. The extent to which future revenue fluctuations could occur due to these factors is not known and cannot be predicted. As a consequence, our results of operations are subject to significant fluctuations and our results of operations for any particular quarter or fiscal year may not be indicative of results of operations for future periods. A significant portion of our operating expenses are fixed, and are based primarily on revenue and sales forecasts. Any inability on our part to reduce spending or to compensate for any failure to meet sales forecasts or receive anticipated revenues could magnify the adverse impact of such events on our operating results.

The Majority Of Our Contracts With Customers May Be Terminated For Convenience

The majority of our contracts with customers are terminable upon short notice for the convenience of either party. Although to date none of our material contracts have ever been terminated under these provisions, we cannot be assured that a material contract will not be terminated for convenience in the future. Any termination of a material contract, if not replaced, could have a material adverse effect on our business, financial condition and results of operations.

We Face Significant Competition For Our Services

Competition for our services is expected to increase. Increased competition could result in reductions in our prices, gross margins and market share. We compete with other providers of healthcare information management and data processing services, as well as healthcare consulting firms. Some competitors have formed business alliances with other competitors that may affect our ability to work with some potential customers. In addition, if some of our competitors merge, a stronger competitor may emerge.

Current and prospective customers also evaluate our capabilities against the merits of their existing information management and data processing systems and expertise. Major information management systems companies, including those specializing in the healthcare industry, that do not presently offer competing services may enter our markets. Many of our potential competitors have significantly greater financial, technical, product development, marketing and other resources, and market recognition than we have. As a result, our competitors may be able to respond more quickly to new or emerging technologies, changes in customer requirements and changes in the political, economic or regulatory environment in the healthcare industry. In addition, several of our competitors may be in a position to devote greater resources to the development, promotion, and sale of their services than we can.

Simplification Of The Healthcare Payment Process Could Reduce The Need For Our Services

The complexity of the healthcare payment process, and our experience in offering services that improve the ability of our customers to recover incremental revenue through that process, have been contributing factors to the success of our service offerings. Complexities of the healthcare payment process include multiple payors, and the coordination and utilization of clinical, operational, financial and/or administrative review instituted by third-party payors in an effort to control costs and manage care. If the payment processes associated with the healthcare industry are simplified, the need for our services, or the price customers are willing to pay for our services, could be reduced.

Changes In The United States Healthcare Environment Could Have A Material Negative Impact On Our Revenue And Net Income

The healthcare industry in the United States is subject to changing political, economic and regulatory influences that may affect the procurement practices and operations of healthcare organizations. Our services are designed to function within the structure of the healthcare financing and reimbursement system currently being used in the United States. During the past several years, the healthcare industry has been subject to increasing levels of governmental regulation of, among other things, reimbursement rates, certain capital expenditures, and data confidentiality and privacy. From time to time, certain proposals to reform the healthcare system have been considered by Congress. These proposals, if enacted, may increase government involvement in healthcare, lower reimbursement rates and otherwise change the operating environment for our clients. Healthcare organizations may react to these proposals and the uncertainty surrounding such proposals by curtailing or deferring their retention of service providers such as us. We cannot predict what impact, if any, such proposals or healthcare reforms might have on our results of operations, financial condition or business.

We Are Subject To Extensive Government Regulation, And Any Violation Of The Laws And Regulations Applicable To Us Could Reduce Our Revenue And Profitability And Otherwise Adversely Affect Our Operating Results.

Our business is regulated by the federal government and the states in which we operate. The laws and regulations governing our operations are generally intended to benefit and protect health plan members and providers rather than stockholders. The government agencies administering these laws and regulations have broad latitude to enforce them. These laws and regulations, along with the terms of our government contracts, regulate how we do business, what services we offer, and how we interact with our clients, providers and the public. We are subject, on an ongoing basis, to various governmental reviews, audits and investigations to verify our compliance with our contracts and applicable laws and regulations

Because we receive payments from federal and state governmental agencies, we are subject to various laws, including the Federal False Claims Act, which permit the federal government to institute suit against us for violations and, in some cases, to seek treble damages, penalties and assessments. Many states, including states where we currently do business, likewise have enacted parallel legislation. In addition, private citizens, acting as whistleblowers, can sue as if they were the government under a special provision of the Act.

The General Accounting Office, an investigative arm of Congress, has included Medicaid on its list of high-risk programs. According to the GAO, states have used various financing schemes to generate excessive federal Medicaid matching funds while their own share of expenditures has remained unchanged or decreased. Also on January 30, 2004, the United States Senate Finance Committee Chairman requested that the HHS, CMS, and OIG respond to a lengthy request for information about vendors that provide contingency fee based revenue maximization or revenue enhancement services to State Medicaid agencies specifically with the intent to increase federal Medicaid reimbursement. This type of service represents a very small portion of the suite of HMS offerings and corresponding revenue streams. We cannot predict what impact, if any, this inquiry might have on our future results of operations, financial condition or business.

Any violations of any of these laws, rules or regulations or any adverse review, audit or investigation could reduce our revenues and profitability and otherwise adversely affect our operating results.

We Must Comply With Restrictions On Patient Privacy And Information Security, Including Taking Steps To Ensure That Our Business Associates Who Obtain Access To Sensitive Patient Information Maintain Its Confidentiality.

The use of individually identifiable data by our businesses is regulated at the federal and state levels. These laws and rules are changed frequently by legislation or administrative interpretation. Various state laws address the use and disclosure of individually identifiable health data. Most are derived from the privacy and security provisions in the federal Gramm-Leach-Bliley Act and the Health Insurance Portability and Accountability Act of 1996, (HIPAA). HIPAA also imposes guidelines on our business associates (as this term is defined in the HIPAA regulations). Even though we provide for appropriate protections through our contracts with our business associates, we still have limited control over their actions and practices. Compliance with these proposals, requirements, and

new regulations may result in cost increases due to necessary systems changes, the development of new administrative processes, and the effects of potential noncompliance by our business associates. They also may impose further restrictions on our use of patient identifiable data that is housed in one or more of our administrative databases.

Our Businesses Depend On Effective Information Systems And The Integrity Of The Data In Our Information Systems.

Our ability to adequately price our products and services, provide effective and efficient service to our customers, and to accurately report our financial results depends on the integrity of the data in our information systems. As a result of our acquisition activities, we have acquired additional systems. We have been taking steps to reduce the number of systems we operate. If the information we rely upon to run our businesses was found to be inaccurate or unreliable or if we fail to maintain our information systems and data integrity effectively, we could lose existing customers, have difficulty attracting new customers, have problems in establishing appropriate pricing, have disputes with customers and other health care providers, have regulatory problems, have increases in operating expenses or suffer other adverse consequences.

We Depend On Information Suppliers. If We Are Unable To Manage Successfully Our Relationships With A Number Of These Suppliers, The Quality And Availability Of Our Services May Be Harmed.

We obtain some of the data used in our services from third party suppliers and government entities. If a number of suppliers are no longer able or are unwilling to provide us with certain data, we may need to find alternative sources. If we are unable to identify and contract with suitable alternative data suppliers and integrate these data sources into our service offerings, we could experience service disruptions, increased costs and reduced quality of our services. Additionally, if one or more of our suppliers terminates our existing agreements, there is no assurance that we will obtain new agreements with third party suppliers on terms favorable to us, if at all. Loss of such access or the availability of data in the future due to increased governmental regulation or otherwise could have a material adverse effect on our business, financial condition or results of operations.

We Depend On Our Largest Clients For Significant Revenue, And If We Lose A Major Client, Our Revenue Could Be Adversely Affected.

We generate a significant portion of our revenue from our largest clients. For the years ended December 31, 2006, 2005, and 2004, our three largest clients accounted for approximately 27%, 39% and 41% of our revenue from continuing operations, respectively. If we were to lose a major client, our results of operations could be materially and adversely affected by the loss of revenue, and we would seek to replace the client with new business.

The Level Of Our Annual Profitability Has Historically Been Significantly Affected By Our Third and Fourth Quarter Operating Results.

We typically realize higher revenues and operating income in the last half of our fiscal year. This trend reflects the operational cycles of our clients. Although we currently anticipate that our revenue and profit in the fourth quarter of 2007 will be greater than comparable amounts for the earlier quarters of 2007, if we do not realize increased revenue in future third and fourth quarter periods, including 2007, due to adverse economic conditions in those quarters or otherwise, our profitability for any affected quarter and the entire year could be materially and adversely affected because ongoing data processing and general and administrative expenses are largely fixed.

Successful Integration Of BSPA Into The Company Is Dependent On Several Factors, And The Failure To Realize The Expected Benefits Of The Acquisition Of BSPA Could Have An Adverse Effect On Our Operations.

We acquired BSPA from PCG on September 13, 2006, and, as a result, we significantly increased the size of our operations and business. We cannot assure you that we will be able to integrate the operations of the BSPA without encountering difficulties. Any difficulty in integrating the operations of BSPA successfully could have a material adverse effect on our business, financial condition, results of operations or prospects, and could lead to a

failure to realize the anticipated benefits of the acquisition. Moreover, our management will be required to dedicate substantial time and effort to the integration of BSPA. During the integration process, these efforts could divert management's focus and resources from other strategic opportunities and operational matters.

Our Indebtedness Results In Significant Debt Service Obligations And Limitations.

We have significant debt service obligations. Substantially all of our assets used in our business operations secure our obligations under our credit facilities. Our indebtedness may pose important consequences to investors, including the risks that:

- we will use a substantial portion of our cash flow from operations to pay principal and interest on our debt, thereby reducing the funds available for acquisitions, working capital, capital expenditures and other general corporate purposes;
- increases in our borrowings under our credit facilities may make it more difficult to satisfy our debt obligations;
- our borrowings under our credit facilities bear interest at variable rates, which could create higher debt service requirements if market interest rates increase;
- our degree of leverage may limit our ability to withstand competitive pressure and could reduce our flexibility in responding to changes in business and economic conditions;
- our degree of leverage may hinder our ability to adjust rapidly to changing market conditions and could make us more vulnerable to downturns in the economy or in our industry; and
- our failure to comply with debt covenants could result in our indebtedness being immediately due and payable

If we cannot generate sufficient cash flow from operations to meet our obligations, we may be forced to reduce or delay acquisitions and other capital expenditures, sell assets, restructure or refinance our debt, or seek additional equity capital. There can be no assurance that these remedies would be available or satisfactory. Our cash flow from operations will be affected by prevailing economic conditions and financial, business and other factors that may be beyond our control.

We May Not Be Able To Realize The Entire Book Value Of Goodwill And Other Intangible Assets From Acquisitions

As of December 31, 2006, we have approximately \$65.2 million of goodwill and \$28.4 million of intangible assets. We have implemented the provisions of Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," which requires that existing goodwill not be amortized, but instead be assessed annually for impairment or sooner if circumstances indicate a possible impairment. We will monitor for impairment of goodwill on past and future acquisitions. We perform our impairment testing in the second quarter of each year. In the event that the book value of goodwill is impaired, any such impairment would be charged to earnings in the period of impairment. There can be no assurances that future impairment of goodwill under SFAS No. 142 will not have a material adverse effect on our business, financial condition or results of operations. Management performs the goodwill valuation.

**Certain Provisions In Our Certificate Of Incorporation Could Discourage Unsolicited Takeover Attempts,
Which Could Depress The Market Price Of Our Common Stock**

Our certificate of incorporation authorizes the issuance of up to 5,000,000 shares of “blank check” preferred stock with such designations, rights and preferences as may be determined by our Board of Directors. Accordingly, our Board of Directors is empowered, without shareholder approval, to issue preferred stock with dividend, liquidation, conversion, voting or other rights, which could adversely affect the voting power or, other rights of holders of our common stock. In the event of issuance, preferred stock could be utilized, under certain circumstances, as a method of discouraging, delaying or preventing a change in control. Although we have no present intention to issue any shares of preferred stock, we cannot assure you that we will not do so in the future. In addition, our by-laws provide for a classified Board of Directors, which could also have the effect of discouraging a change of control.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

Our New York City corporate headquarters consists of approximately 81,000 square feet of leased space. In addition, as of December 31, 2006, we lease approximately 146,000 square feet of office space in 24 other locations throughout the United States. See Note 15(d) of the Notes to Consolidated Financial Statements for additional information about our lease commitments.

Item 3. Legal Proceedings

Legal proceedings to which we are a party, in the opinion of our management, are not expected to have a material adverse effect on our financial position, results of operations, or liquidity.

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock is included in the Nasdaq Stock Market (symbol: HMSY). As of the close of business on March 7, 2007, there were approximately 6,000 holders of record of our common stock, including the individual participants in security position listings. We have not paid any cash dividends on our common stock and do not anticipate paying cash dividends in the foreseeable future. Our current intention is to retain earnings to support the future growth of our business.

The table below summarizes the high and low sales prices per share for our common stock for the periods indicated, as reported on the Nasdaq Stock Market.

	<u>HIGH</u>	<u>LOW</u>
Year ended December 31, 2006:		
Quarter ended December 31, 2006	\$16.20	\$12.00
Quarter ended September 30, 2006	14.78	10.03
Quarter ended June 30, 2006	11.39	7.93
Quarter ended March 31, 2006	9.00	7.16
Year ended December 31, 2005:		
Quarter ended December 31, 2005	\$8.10	\$6.75
Quarter ended September 30, 2005	8.04	6.56
Quarter ended June 30, 2005	7.90	5.88
Quarter ended March 31, 2005	8.98	6.56

Equity Compensation Plan Information

The following table summarizes the total number of outstanding options and shares available for other future issuances of options under all of our equity compensation plans as of December 31, 2006.

<i>Plan Category</i>	<i>Number of securities to be issued upon exercise of outstanding warrants, options and rights</i> <i>(a)</i>	<i>Weighted-average exercise price of outstanding warrants, options and rights</i> <i>(b)</i>	<i>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</i> <i>(c) ⁽²⁾</i>
Equity Compensation Plans approved by Shareholders ⁽¹⁾	3,794,156	\$5.32	563,100
Equity Compensation Plans not approved by Shareholders ⁽³⁾	1,185,000	\$7.53	-
Total	4,979,156	\$5.85	563,100

(1) This includes options to purchase shares outstanding: (i) under the 2006 Stock Plan, (ii) under the 1999 Long-Term Incentive Plan, (iii) the 1995 Non-Employee Director Stock Option Plan, and (iv) 250,000 options approved by shareholders and granted to a director in June 2002.

(2) These shares remain available for issuance under the 2006 Stock Plan.

(3) Options issued under plans not approved by the shareholders include (i) 600,000 options granted in March 2001 to our Chairman and Chief Executive Officer in connection with his joining us, and (ii) 585,000 inducement options granted in September 2006 to ten former senior executives of BSPA in connection with their joining us.

Issuer Purchases of Equity Securities

On May 28, 1997, the Board of Directors authorized the Company to repurchase such number of shares of our common stock that have an aggregate purchase price not to exceed \$10 million. On February 24, 2006, the Board of Directors increased the authorized aggregate purchase price by \$10 million to an amount not to exceed \$20 million. During the years ended December 31, 2006 and 2004, there were no repurchases. During the year ended December 31, 2005, we repurchased 17,930 shares for \$109,000. At December 31, 2006, \$10.6 million remains authorized for repurchases under the program.

Item 6. Selected Financial Data

SELECTED CONSOLIDATED FINANCIAL DATA

The following table sets forth selected consolidated financial data at and for each of the five fiscal years in the period ended December 31, 2006. It should be read in conjunction with the Consolidated Financial Statements and Notes thereto, included in Item 8 of this Report, and Management's Discussion and Analysis of Financial Condition and Results of Operations, included in Item 7 of this Report.

	Years ended December 31,				
	2006	2005	2004	2003	2002
Statement of Operations Data:					
<i>(in thousands, except per share data)</i>					
Revenue	\$87,940	\$60,024	\$50,451	\$42,823	\$35,251
Cost of services	80,115	52,448	45,327	41,562	39,498
Operating income (loss)	7,825	7,576	5,124	1,261	(4,247)
Interest expense	(955)	-	-	-	-
Net interest and net other income	1,627	1,238	313	250	521
Income (loss) from continuing operations before income taxes	8,497	8,814	5,437	1,511	(3,726)
Income tax expense	3,588	465	103	35	-
Income (loss) from continuing operations	4,909	8,349	5,334	1,476	(3,726)
Discontinued operations:					
Income from discontinued operations, net	416	839	2,377	872	4,661
Estimated loss on disposal of discontinued operations, net	-	(1,161)	-	-	-
Income (loss) from discontinued operations	416	(322)	2,377	872	4,661
Net income	\$ 5,325	\$ 8,027	\$ 7,711	\$ 2,348	\$ 935
Per Common Share Data:					
Basic income (loss) per share:					
From continuing operations	\$ 0.23	\$ 0.42	\$ 0.28	\$ 0.08	\$ (0.20)
From discontinued operations	0.02	(0.01)	0.12	0.05	0.25
Total	\$ 0.25	\$ 0.41	\$ 0.40	\$ 0.13	\$ 0.05
Weighted average common shares, basic	21,731	19,865	19,074	18,330	18,199
Diluted income (loss) per share:					
From continuing operations	\$ 0.21	\$ 0.37	\$ 0.24	\$ 0.07	\$ (0.20)
From discontinued operations	0.01	(0.01)	0.11	0.05	0.25
Total	\$ 0.22	\$ 0.36	\$ 0.35	\$ 0.12	\$ 0.05
Weighted average common shares, diluted	23,859	22,287	22,275	20,132	18,199

SELECTED CONSOLIDATED FINANCIAL DATA, continued

	December 31, 2006	December 31, 2005	December 31, 2004	December 31, 2003	December 31, 2002
Balance Sheet Data:					
Cash and short-term investments	\$ 12,527	\$ 41,141	\$ 31,696	\$ 26,715	\$ 25,282
Working Capital	25,264	52,535	44,147	36,197	28,625
Total assets	157,243	87,601	76,663	63,123	61,666
Long-term debt	23,625	-	-	-	-
Shareholders' equity	106,907	72,769	60,398	50,607	47,768

Notes to Selected Consolidated Financial Data

- **Discontinued Operations.** In 2005, we sold the business of our former subsidiary, Accordis Inc.(Accordis). As this business was previously presented as a separate reportable segment and represented a separate class of customer and major business, the operating results are presented as discontinued operations for all periods presented.
- On January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards 123 (revised 2004), "Share-Based Payment" (SFAS 123R), which requires that the costs resulting from all share-based payment transactions be recognized in the financial statements at fair value. The Company adopted SFAS 123R using the modified prospective application method under which the provisions of SFAS 123R apply to new awards and to awards modified, repurchased, or cancelled after the adoption date. Additionally, compensation cost for the portion of the awards for which the requisite service has not been rendered that are outstanding as of the adoption date is recognized in the consolidated statement of operations over the remaining service period after the adoption date based on the award's original estimate of fair value. Prior to January 1, 2006, the Company accounted for stock-based compensation under the recognition and measurement principles of Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees" (APB 25), and related interpretations. No compensation expense related to stock option plans was reflected in the Company's consolidated statements of operations as all options had an exercise price equal to the market value of the underlying common stock on the date of grant. Results for prior periods have not been restated. Total share-based compensation expense recorded in the consolidated statement of income for the year ended December 31, 2006 was \$1.7 million. As a result of adopting SFAS 123R on January 1, 2006, the Company's net income for the year ended December 31, 2006 is \$1.0 million lower than if it had continued to account for share-based compensation under APB 25.
- In September 2006, the SEC released Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 permits the Company to adjust for the cumulative effect of immaterial errors relating to prior years in the carrying amount of assets and liabilities as of the beginning of the current fiscal year, with an offsetting adjustment to the opening balance of retained earnings in the year of adoption. SAB 108 also requires the adjustment of any prior quarterly financial statements within the fiscal year of adoption for the effects of such errors on the quarters when the information is next presented. Such adjustments do not require previously filed reports with the SEC to be amended. In accordance with SAB 108, the Company has adjusted its opening retained earnings for 2006 by decreasing retained earnings by \$360,000 (net of tax).

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

We begin Management's Discussion and Analysis of Financial Condition and Results of Operations with a discussion of the critical accounting policies that we believe are important to understanding the assumptions and judgments incorporated in our reported financial results. In the next section, we present an overview of our business